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REPORT OF THE EXPERT MEETING ON AIR TRANSPORT SERVICES: CLARIFYING ISSUES TO DEFINE THE ELEMENTS OF THE POSITIVE AGENDA OF DEVELOPING COUNTRIES AS REGARDS BOTH THE GATS AND SPECIFIC SECTOR NEGOTIATIONS OF INTEREST TO THEM

Held at the Palais des Nations, Geneva,
from 21 to 23 June 1999

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I. AGREED CONCLUSIONS [1]

The Expert Meeting reached the following conclusions on issues which should be taken into account in building the positive agenda for developing countries in the air transport sector:

A. Progressive liberalization under current arrangements

1. The current Annex on Air Transport in the General Agreement on Trade in Services (GATS) rules out its application to traffic rights and services related to traffic rights. The Annex does, however, list three services related to air transport to which the rules of the GATS do apply. Commitments so far in these three sectors are limited.

2. With a view to identifying possible benefits from further commitments in the areas already listed in paragraph 3 of the Annex, the GATS signatories are urged to review their commitments and to consider the options for including these sectors in their packages of offers and requests.

3. In a number of other areas, the application of the GATS may be unclear. There is a need to clarify the coverage under the existing wording by considering a more detailed classification of the air transport sector, including related activities. The coverage of the Agreement can then be tested more easily.

4. Options for extending the coverage of items similar to those now listed in paragraph 3 of the Annex could then also be considered.

5. This work, involving cooperation among the International Air Transport Association (IATA), the International Civil Aviation Organization (ICAO) and the World Trade Organization (WTO), should include the comparison of the sectoral classifications now used in the GATS with those in common use in the industry.

B. Considering ways of extending the coverage

6. Options for the inclusion of air transport in the GATS should continue to be explored in order to understand more completely the role that the GATS can play in resolving the issues outlined above. In order to have an impact on the debate on air transport in the WTO Council for Trade in Services, participants must have an appreciation of the options and their implications.

7. Under the GATS, WTO members may claim exemptions from most-favoured-nation (MFN) treatment for some parts of the sector. Commitments on market access and national treatment apply only to those parts of the sector that are bound in each country's schedules.

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[1] As adopted by the Expert Meeting at its closing plenary meeting on 23 June 1999.

8. In preparing for the review of the Annex, WTO members might wish to explore, among others, the following options:

(a) It may be the case that a large number of economies wish to exclude, in particular, mode 1 (that is, supply across a national border, which means that the airline provides the service from its home base). If so, the current Annex could be amended to:

(i) specify that the exemption applies only to this mode, and

(ii) make clear which elements of the activity are included (related only to traffic rights, but to be defined more precisely as a consequence of the work done on the definition of the sector);

(b) Mode 2, which refers to consumption abroad, may be less controversial, but its scope has to be tested in the negotiation process;

(c) Mode 3, which refers to commercial presence, is increasingly common. Coverage of this mode by the GATS adds to the adjustment options of airlines based in developed economies and also adds to the modes of participation by developing economies. There is evidence that rules on establishment that are applied in the bilateral system are becoming more flexible and more open. Scheduling this mode of delivery would recognize this fact and provide the benefits of the GATS, in terms of MFN, market access and national treatment;

(d) Commitments with respect to the movement of persons under mode 4 would also be relevant;

(e) This approach to treatment of air transport would have to consider the consistency between the GATS approach to defining national identity and that applied in the bilateral air transport system. Dealing with competition policy issues also requires the identification of the home base of the airline, since it will be important to be able to identify a jurisdiction to which a complaint may be taken. The flexibility already evident in the definition of carrier identity in the bilateral agreements indicates that this issue need not be a significant constraint.

9. Members may also wish to consider including under paragraph 3 of the Annex additional specific air transport services and activities, as well as reducing the list of specific services, activities and/or traffic rights under paragraph 2 of the Annex, taking into account the results of the work set out in paragraphs 2 to 5 above.

C. Treatment of developing countries

10. In recognition of the concern expressed by developing countries on the need to improve their participation in air transport markets on a level playing field, a number of suggestions have been developed by ICAO, IATA, specialized regional organizations and member States for mechanisms to achieve that goal. These mechanisms represent transitional measures, and it is

recommended that they be studied and considered. The organizations responsible for air transport should be invited to take part in the development and management of these options.

11. The ICAO secretariat has developed a number of recommendations for mechanisms through which this support could be provided. These refer to the terms of market access, the application of criteria on ownership and control, processes of slot allocation, and doing business matters. These recommendations should be re-examined. Implementation of these options is a matter for individual economies.

12. In addition, there are important contributions which can be made to capacity-building, for example, with respect to competition policy, standards (including those related to environmental issues, such as noise and industry doing-business standards) and human resource development. It is recommended that cooperation for these purposes be pursued in a number of modes, including under the auspices of ICAO and IATA, where relevant.

13. Consideration of the application of the GATS to air transport should also cover its implications for special provisions for developing country participation. Article IV obliges members to facilitate the increasing participation of developing countries in world trade in services through negotiated specific commitments, such as those relating to access to technology on a commercial basis and improvement of access to distribution channels and information networks. It would be useful to evaluate how Article IV has worked in general as well as its possible application to the air transport sector.

14. Article XXV refers to the scope for the WTO Council for Trade in Services to provide technical assistance by the WTO secretariat. This will be valuable in the context of making choices about documenting commitments if and when the air transport exemption is removed.

D. Dealing with competition policy and other regulatory issues

15. It is important to deal with competition policy problems and with the application of domestic regulation, which can lead to demands for conflict resolution. Difficulties have been experienced in conflict resolution in the bilateral system. Conflicts could arise from commercial decisions by airlines or from government practices which have a direct effect – for example, on access – or an indirect effect – for example, as a result of sanctioning some form of airline behaviour in the marketplace. While a multilateral consensus on competition policy issues is being pursued, other options for arrangements which are specific to air transport could be pursued while safeguarding the industry cooperation needed to set standards and maintain interlining worldwide so as to preserve the integrity of the global network.

16. The GATS has provisions which can be used to deal with competition and regulatory issues. Various articles are relevant, but especially those on domestic regulation (VI), monopoly and exclusive service suppliers (VIII), business practices (IX), safeguard measures (X) and subsidies (XV). These provisions, however, can only be invoked by States and in situations where States are involved, be it directly through their action (subsidies, safeguards, domestic regulation) or indirectly through their jurisdiction over service suppliers, monopolies or exclusive service suppliers. Furthermore, these provisions have generally not been tested or developed, and further attention should be given to ways of strengthening the contribution of the GATS through them.

17. The WTO Reference Paper on basic telecommunications should also be examined as a model for how competition policy issues in particular could be dealt with in air transport. This paper refers to competitive safeguards (e.g. anti-competitive cross-subsidies, denial of access to services), rules on interconnection (in the case of air transport, access to infrastructure), treatment of universal service obligations, transparency, rules on the allocation of scarce resources such as frequencies (in the case of air transport, landing slots or gates) and the value of having regulators who are independent of service providers. Similar work on other transport modes should also be examined.

18. An important suggestion by ICAO, based on its earlier work, was for States to use a safeguard mechanism on anti-competitive practices, including a dispute settlement and conciliation process which could also be applied at enterprise level.

19. ICAO can work with WTO on clarifying various regulatory practices.

20. States are invited to implement expeditiously their National Communication Navigation Surveillance and Air Traffic Management Systems(CNS/ATM), which have been included in their regional air navigation plans, so as to alleviate airport and airspace congestion and to facilitate reform of regulatory policy.

E. The regional route to reform

21. The number of active regional arrangements is increasing. There are at least 11 such arrangements in various stages of development.

22. A regional approach to reform has a number of advantages, such as the development of cooperation among participants, competition within the region, the development of service to subregions, the consolidation and restructuring of airlines, greater efficiency within the region, making a contribution to competitiveness on routes outside the region, and so on. A regional approach can also affect market access.

23. The GATS provisions in Article V apply to regional arrangements only when they are part of a larger structure which has substantial sectoral coverage. Developing countries do have some flexibility in the application of regional arrangements, but it may not be sufficient to support arrangements which apply to one sector. Some of the existing air transport arrangements are part of larger economic integration arrangements which are covered by Article V. In such cases the application of the GATS to air transport would impose disciplines on these arrangements.

24. There is not yet sufficient information to make a judgement about the effects of these arrangements. It is recommended that further work be completed on the costs and benefits of the regional approach to reform. Regional arrangements could be characterized by their rules (e.g. transparency, accession, terms of market access for non-members, human resource development, etc.), and the links between these rules and economic outcomes could be analysed. The results could be used to design some principles for this route to reform in the absence of GATS rules, or to facilitate the reporting of such arrangements to the WTO Council for Trade in Services if the GATS does apply.

F. Preparation for negotiations

25. UNCTAD, in collaboration with ICAO, its regional agencies and other relevant international and regional bodies, should work with developing countries on these options and the construction of the positive agenda.

II. CHAIRPERSON'S SUMMARY

A. Background

26. Overall, the main concern of developing countries with respect to air transport, as it emerged from discussions during the Expert Meeting, is the terms of their participation in world air transport markets. One view is that these countries will benefit from competitive international air transport markets, since markets which are competitive are more open to their participation. Competitive markets also provide services at efficient levels, which facilitates the growth of industries that use air transport services, including tourism, and those that use air freight. However, competitive markets also involve challenges. This is especially the case for airlines emerging from systems of regulation, which previously provided them with a degree of protection, and from government ownership. At the same time, the trend towards privatization has tightened the financial constraints on many flag carriers.

27. At present, international markets are subject to complex regulation based on a system of bilateral agreements. This system continues to evolve because of pressures from the market. The system also remains outside the rules of international trading arrangements. A review of the system by the World Trade Organization (WTO) is inevitable under commitments made in the Uruguay Round. The question is how to manage the transition to new arrangements. There are a number of options. The outcome is likely to involve some combination of reform from within the bilateral system, as a consequence of the imposition of the rules of the multilateral system. The latter are embodied in the General Agreement on Trade in Services (GATS), and many participants at the Expert Meeting asked how the use of GATS as a vehicle for reform would benefit developing countries. They noted the change already achieved under the bilateral system with guidance from the International Civil Aviation Organization (ICAO).

28. The bilateral system does offer access to markets, but the scope of that access is neither unlimited nor highly flexible, since it is subject to specific reciprocity. Furthermore, disagreement over the terms of access can be settled only within the bilateral structure, where bargaining power is uneven. The bilateral system is now transforming itself. There have been substantial changes in bilateral agreements. Many are now more open. Airlines are finding ways of cooperating despite the constraints imposed on them by bilateralism. Countries are experimenting with regional approaches to reform.

29. There are risks, from a policy perspective, in the current path of development of the sector, including in the emergence of new competition policy issues. The latter include the behaviour of alliances of airlines, which are becoming increasingly important, and the terms of access to critical infrastructure. There are also concerns about the emergence of new forms of discrimination even within apparently open arrangements. These include the manner in which various technical regulation processes are administered.

30. Rather than simply letting the bilateral system evolve, an alternative is to use the opportunity of the review of the GATS Annex on Air Transport Services by the WTO Council on Trade in Services to move more rapidly to a more open system based on the rules of the multilateral system. This would remove the specific reciprocity of the current arrangements and contribute to greater gains from trade in these services, as well as to more competitive markets,

but it too would have to deal with competition policy questions and with the new forms of discrimination.

31. A complete review of all the options was beyond the scope of the Meeting. The immediate priority was to contribute to an evaluation of the route to reform through GATS. The discussion by experts led to suggestions about international cooperation in the development and transformation of the bilateral system. The focus on this occasion was on the application of GATS or of the principles of GATS for this purpose. The objective was to develop a positive agenda for developing countries in that context. Reference was also made to the role that could be played by ICAO, which has had a wide-ranging technical and economic regulatory role in the air transport industry.

B. Opening statements

32. In his opening address, the **Secretary-General of UNCTAD** said that air transport services were one of the driving forces behind globalization. They were key contributors to the development of tourism services in developing countries and provided new opportunities for the export of goods and other services, including through the movement of business people. Air transport services had been pioneers in the development of electronic commerce, another force behind globalization, owing to the development of remote computer reservation systems (CRS) and global distribution systems (GDS). The timing of the Expert Meeting was very propitious, since WTO was about to undertake a review of the GATS Annex on Air Transport Services with a view to considering the possible further application of GATS in that sector and was preparing for a round of negotiations progressively to liberalize trade in services and increase the level of commitments under the Agreement. Air traffic rights and services directly related to the exercise of those rights were the only services excluded from its otherwise universal coverage.

33. He explained the main features of UNCTAD's initiative on the positive trade agenda for developing countries and stressed that the Expert Meeting was part of that initiative. Accordingly, the Meeting's conclusions could be translated into possible negotiating objectives within the framework of WTO and ICAO. The background note prepared for the Meeting by the secretariat already contained some possible elements for a positive agenda, such as the suggestions that the ancillary services already covered by GATS could be further liberalized and that more services could be brought within the schedules of commitments by extending GATS to those services currently excluded from it which were directly related to the exercise of traffic rights.

34. The review of the Annex on Air Transport Services would constitute a major test of the credibility of GATS article IV, which was aimed at increasing the participation of developing countries in trade in services. That could be achieved through improved access for developing countries to technology, information networks and distribution channels. The WTO negotiations on GATS article IX, on competition policy, and article XV, on the prevention of distortions arising from subsidies for services, would be relevant to that review process. He recalled that traffic rights were governed by a network of bilateral agreements which made the application of the most favoured nation (MFN) principle very difficult. While the bilateral agreements might have sheltered developing countries' airlines from the ravages of predatory competition, they also placed them in a situation where they had limited negotiating leverage to acquire improved market access. The Meeting could therefore offer some ideas on how the MFN principle could be applied

to traffic rights, an area in which the most constructive ideas had come from ICAO. Its nine preferential measures, if applied on a universal and contractual basis, could serve to compensate for the weaker position of developing countries in bilateral negotiations on improved market access.

35. The **Secretary-General of ICAO** stressed the contribution of air transport to economic progress and development. It was not a viable option for developing countries to leave the provision of reliable services and connections to the disciplines and consequences of the international market place. The guiding principles of the Chicago Convention, which represented ICAO's constitution, were non-discrimination, transparency and equality of opportunity. ICAO focused its efforts on establishing minimum standards for safety and security, but it also anticipated and responded to needs across the whole air transport spectrum. Air transport was a fast-moving business where technology, marketing and service delivery were constantly pushing towards new horizons. Traditionally, most Governments not only set policy and regulated the air transport sector but also acted as service providers. However, they were rethinking their regulatory function and role as service providers.

36. He summarized some of the most important initiatives in which ICAO had been involved and which had the efficiency, growth and safety of commercial air transport as their rationale. ICAO had taken an extremely complex and far-reaching initiative to transform the communications, navigation, surveillance and air traffic management aspects of aircraft in flight from a ground-based to a satellite-based system. A global aviation safety plan was being carried out to evaluate the implementation of ICAO's minimum standards. The organization had developed a fully operational mechanism of assistance and training for States to combat unlawful interference with civil aviation, such as hijacking. An initiative had been taken to broaden the sources and mechanisms for funding the aviation infrastructure, especially in developing countries. ICAO was developing guidance to help countries adapt their economic regulatory responsibilities to a globalizing, privatizing and liberalizing world and an increasingly competitive market place.

37. The sector's expansion could lead to new problems. In the coming decade it would face an enormous demand for investment in infrastructure and in the replacement of equipment. The question was not whether to pursue liberalization but how. Every country would approach liberalization at its own pace and in accordance with its needs and circumstances, with economic progress as the final goal. The sector depended heavily on global cooperation, coordination and competition, and the challenge was to establish the best mix of those factors for each particular circumstance.

38. The **Director-General of the International Air Transport Association (IATA)** explained why there was a limited coverage of air transport services in GATS 1995. Negotiators had recognized that international air transport operated through a system of over 3,500 bilateral agreements. That framework had proved sufficiently flexible to allow for the development of consumer-responsive services to increase competition and to foster the continued cooperation needed to run a global system covering 190 countries and serving 1.5 billion passengers a year. The airline industry did not want a dual regulatory regime, with some States applying GATS obligations and others holding to existing arrangements. It wanted to keep the freedom to apply agreements based on reciprocity, not on the MFN principle. Moreover, if new trade concepts were to be applied to air transport, ICAO, as the competent United Nations agency involved, was

best qualified to take into consideration the industry's peculiarities, regulatory arrangements and structures. A compromise solution had thus been sought and a separate annex on air transport concluded, covering only three ancillary services – aircraft repair and maintenance, the sale and marketing of air transport services, and computer reservation system services ("soft rights") – and excluding routes, traffic rights, capacity, ownership and control ("hard rights").

39. Substantial progress had been made in the liberalization of air transport even without the multilateral approach of GATS, through bilateral, plurilateral and regional arrangements, which had resulted in crucial market changes. There was, however, widespread agreement at the government level and throughout the airline community on the need further to liberalize aviation markets, and in that regard the fundamental challenge was to find the best way for the industry to move forward and to determine whether the WTO/GATS approach offered the best solution. A critical component would be the attitude of developing countries, whom the industry believed would use air transport services for bargaining purposes in other sectors, thereby benefiting the countries but not the carriers.

40. He drew the following conclusions:

(a) The aviation community had to become more familiar with GATS and trade negotiators with the specifics of air transport;

(b) A better understanding of what was already included in GATS and a clearer classification of services were needed;

(c) Emerging non-economic obstacles had to be addressed on the basis of the Annex on Air Transport Services;

(d) Bilateral agreements were still useful instruments but they could not be used ad infinitum;

(e) The industry had a strong preference for air transport services to be dealt with on a sectorial basis;

(f) The forthcoming Millennium Round offered the opportunity to examine what obstacles existed and whether GATS could help in solving them; and

(g) If hard rights were brought into GATS, the emerging dual regime would be extremely difficult to manage.

41. The approach of the Millennium Round had reopened the debate on the liberalization process and challenged the industry to think constructively about how a multilateral regime or a combination of regimes could be used to pursue liberalization under a predictable set of rules. IATA planned to formulate a revised position in time for the start of the new negotiations and was searching for the best way to further the liberalization of air transport.

C. Informal discussions

42. The discussions at the Expert Meeting revolved around three main themes: the contribution and coverage of GATS; competition policy issues; and bilateral agreements and regional initiatives.

1. Contribution and coverage of GATS

43. Even though only three areas are included in the GATS Annex on Air Transport Services, the so-called soft rights, experts concurred that liberalization has been taking place in all areas and that the results of the forthcoming review of the Annex will have to be approved by consensus. Commitments have been limited in those three areas, and exemptions have outnumbered the commitments. Any improvement in market access will have to come from improved commitments.

44. While liberalization of the air transport sector is the long-term objective, many experts argued that countries should be able to pursue it at their own rate. They also referred to the preferential measures developed by ICAO as a model to be considered for facilitating the implementation of reforms. Any preferential measures in favour of developing countries should, however, be time-limited.

45. The effective participation of developing countries in the negotiations on services, and in the review of the Annex, will depend on the active involvement of their air transport authorities. Developing countries should have a clear vision and be aware of what should be expected in every segment of the air transport services, as market access will be further opened to competitive suppliers. Technical cooperation extended by WTO to developing countries under article XXV should help build their understanding. Some experts from developing countries asked for increased technical assistance in training and equipment, including new safety equipment.

46. Changes in the structure of the air transport industry may bring confusion and conflicts, making dispute settlement an increasingly relevant issue. There are at present several layers of dispute settlement: arbitration is usually included in the bilateral agreements, ICAO has developed a procedure for conflict resolution, and the WTO dispute settlement procedure is available for the sectors included in the Annex.

47. Experts called for accuracy in the use of the GATS terminology, with one expert requesting a clear definition of "specialized services" and "airport slots" as well as the *identification of leasing, catering, fuelling and airport services for the air transport services sector*. A detailed definition of the sector, in use by the industry and Governments, has been established by ICAO, but definition issues are complicated by the constant changes in the industry itself. Concerning GATS, however, experts were of the view that there was more than one possible interpretation of which ancillary services were covered by the Annex (e.g. with respect to ground handling services). Duality in defining hard and soft rights in GATS and in the industry might serve only to further complicate the debate, and clarity should thus be sought on a definition at the outset. In general, GATS followed a flexible approach that allowed members to deviate from agreed definitions in services negotiations if doing so enabled them to be more precise in their

commitments. The debate on definitions could focus not only on what was included in the Agreement, but also on what was excluded from it.

48. In addition, the notion of a "supply of service" in GATS terms might not be applicable in the present case without modification, as it covered the production, distribution, marketing, sale and delivery of service. Marketing and sales in the aviation industry were treated as separate components and were not part of the supply of air transport services.

49. On the other hand, GATS and commitments by countries in other service sectors already covered related services, such as leasing, catering and so forth. If GATS disciplines were to apply to air transport services, and if commitments on these related services extended to air transport services, agreement would be needed. The same would apply to exemptions under article II of GATS (MFN exemptions), since agreement should be reached on applying MFN derogation to air transport services. Recourse to MFN exemptions might be sought on the grounds that it would facilitate the transition from a bilateral to a multilateral framework. Developing countries had benefited from the flexibility accorded to them through the system of bilateral agreements. The only way for them to maintain reciprocity under the GATS framework would be to include reciprocal arrangements in the MFN exemptions. The treatment of cabotage and how MFN treatment would extend to it also merited attention, and in that regard the experience of maritime transport could be of use.

50. Another pertinent aspect was the comparison of the treatment of ownership in GATS with the practice adopted in the industry. The aviation industry in its international practice requires a definition of substantial ownership and effective control. In addition, treatment of ownership in domestic legal systems differs from one country to another. Effective control is most important, but its definition poses problems and retains a high degree of subjectivity. It could also be achieved with a golden share of 1 per cent ownership. Contrary to the maritime industry, where service suppliers had opted for flags of convenience, it was argued that the link between nationality and flag was particularly important in the air transport sector, for example, because of safety and liability issues. However, market trends reflected an increasing need for flexibility in choosing a location from which to supply air services. Ownership would have to be defined in industry-specific terms if GATS disciplines were to apply to the sector.

51. The movement of people across borders posed problems for developing countries, making negotiations on mode 4 an important issue. GATS article VII was also relevant for air transport services, as it related to the recognition of crew members' qualifications. On the other hand, domestic regulation on licensing legal persons was covered by GATS article VI. Some experts were concerned at the application of the general disciplines to the air transport services in accordance with that article, so as not to compromise existing safety standards. They argued that ICAO could maintain its primordial role as a standard-setting body in the air transport sector in a way that was fully compatible with GATS. Thus, the application of the GATS general disciplines developed under article VI should not be incompatible with the standards established by ICAO, including those on safety. In addition, countries might rely on GATS general exceptions regarding safety, as covered by article XIV. Delays in the issuance of licences acted as an effective barrier to the supply of air transport services, an issue addressed in part in article VI.3.

52. A set of options for liberalization was presented by ICAO:

(a) Leave the GATS Annex in its present form, encourage WTO members to increase the number of commitments in the subsectors covered by the Annex and remove existing exemptions;

(b) Clarify the exact scope of the sectors covered by the Annex and expand its coverage by being more specific: if the subsectors were clearly defined, the coverage of the Annex could be extended to all subsectors that did not fall strictly within the terms "traffic rights" and "services directly related to the exercise of traffic rights";

(c) Expand the coverage of the Annex to include, in particular, all cargo and non-scheduled services, as they are generally less regulated under the present bilateral framework and pose fewer strategic problems;

(d) Expand the coverage of the Annex to include the whole air transport sector, in order to accommodate its particular features;

(e) Achieve liberalization through unilateral expansion, which would imply the use of GATS as a liberalization mechanism for unilateral and non-negotiated commitments: this would allow the limited coverage of air transport to be retained but at the same time permit countries to inscribe full traffic rights in their schedules voluntarily and unilaterally, with or without the condition of reciprocity;

(f) Leave the liberalization process to the bilateral and regional agreements and give GATS the role of setting disciplines in the air transport sector only insofar as subsidies, the participation of developing countries, consultation on restrictive business practices and so on are concerned.

53. Experts noted that work was still ongoing to develop a number of GATS disciplines, such as subsidies, safeguards and government procurement, and that any modification that could be agreed on the substantive norms of the Agreement, and the development of new disciplines within its framework, would affect further commitments in air transport services.

2. Competition policy issues

54. The air transport industry is a high-technology and highly capital-intensive industry. It is also very innovative, undergoing transition, and increasingly globalized. It has three distinctive characteristics:

(a) *The sovereignty principle*, which is the basis for the strong nationality factor in air transport. Sovereignty is the cornerstone of the Chicago Convention, which states that every State has complete and exclusive sovereignty over the airspace above its territory. The emphasis on sovereignty has encouraged a bilateral approach to market access. The sector has also developed around the concept of the national carrier. Because of this, air transport markets are bilaterally focused, and

reciprocity is an intrinsic practice in many respects. As a consequence of the national, bilateral and reciprocal framework, many markets tend to be either monopolies or duopolies, or at best oligopolies in competition terms;

(b) *A self-contained governing regulatory system based on bilateralism.* However, the limited world of bilateralism is expanding, because of the emerging phenomenon of regionalism and because of the inclusion in bilateral agreements of the interests of the trade and business community, the tourist community and consumer groups, as opposed to the sole consideration of the policy interests of the Government and the national carrier;

(c) *Expectation of participation,* which finds expression in the concept of the national carrier. Nearly all countries see participation as a strategic necessity, although many developing countries with small markets and limited resources are having to confront the problem of how to participate in international air transport and how to ensure reliable service to trade partners and essential markets. New forms of indirect participation, such as franchising and contracting out, may help to address the participation issue. Alliances can be used to achieve or maintain direct participation where Governments cannot support national airlines. Notwithstanding the nationality factor, airlines, which were once arms of government, have been forced into a commercially driven environment either as privatized or at least profit-motivated carriers.

55. The above-mentioned changes have brought new issues to the fore, such as the application of competition laws, industry concentration, foreign investment participation, consumer protection, and interconnection between rival GDS and CRS. While a multilateral consensus on competition policy issues is being sought, other options for arrangements which are specific to air transport could be pursued, at the same time safeguarding the industry cooperation needed to set standards and maintain interlining worldwide so as to preserve the integrity of the global network.

56. Discussion also focused on the fact that airlines have been undergoing a process of privatization during the past 10 years, with some regions (such as Africa) just beginning the process and others (such as the Americas) having already acquired a great deal of experience. Privatization is obviously not mandatory, but it is one way to leave air transport to the private sector, which may be in a better position to manage it than Governments. The privatization of airlines in developing countries is often part of broader national privatization strategies or of structural adjustment programmes.

57. There are at present more than 600 alliances, all very different from one another. There are also five mega-alliances which are extremely powerful in the market. Alliances are the result of airline strategies. They reflect the globalization process that the air transport sector is undergoing. At present, however, they do not usually involve equity linkages or cross-holdings. Regulators are facing problems in dealing with alliances, since they have to regulate from a national standpoint a phenomenon which is international in nature. Their main concerns seem to be with the approval of individual alliances and the granting of anti-trust immunity. Members of the alliances act as a single entity. For airlines from developing countries, joining an alliance could

be a way to survive. However, alliances are "marriages of convenience", meaning they can be dropped or modified if they do not provide the members with the benefits they are expecting. One expert warned that when alliances include airlines with considerable disparities in size, resources, market power and access to finance and technology, they might entail risks for the weaker partners. In the case of Africa, for example, airlines are going through the process of privatization and becoming involved in alliances, but they are also becoming too dependent on foreign capital and companies.

58. Experts considered that the WTO negotiations on basic telecommunications could be analysed to see whether lessons could be learned that could be applied to the air transport sector. One of the problems addressed in the telecommunications sector, for example, was access to the grid, which is similar to access to airport slots. The portability of numbers in that sector resembles the portability of reservation numbers in air transport.

59. The application of constraints on the use of subsidies is an area where progress could be made.

60. There are two factors likely to limit the expansion of air transport: air congestion and airport congestion, and environmental concerns. In the European Union, the latter considerations are becoming increasingly important, and environmental groups are calling for limits to be imposed by economic instruments on the expansion of international air transport because of its contribution to environmental damage. These two elements might hamper the expansion of the air transport sector, despite liberalization efforts.

61. Safety standards and practices have to be kept in mind in any liberalization policy and should receive priority over any other consideration. ICAO has developed a large set of minimum safety standards.

62. Regulations that would secure a competitive environment in air transport services with an underlying institutional framework in each developing country are necessary if the liberalization of market access is to proceed. The availability of an emergency safeguard mechanism as a temporary fallback option could also support efforts by developing countries further to open their air transport services markets to competition. The development of such a mechanism would probably be less problematic in air transport services than in other service sectors, if only for reasons of quantification. Quantitative restrictions could be imposed, such as a limitation of frequencies.

3. Bilateral agreements and regional initiatives

63. The concept of full market access, where traffic rights are unrestricted to, from and beyond the territories of the partners, is now included in over 50 of the 3,500 bilateral agreements that currently regulate air transport. While this number is very small compared with the total number of agreements, its importance lies in its coverage and in its consequences for other markets. Open agreements can achieve instant market access and therefore do not imply progressive liberalization, but as they are limited to market access, they do not address such issues as right of establishment, foreign direct investment or cabotage.

64. The United States has concluded 35 of its own type of "open-skies" agreement, and was the initiator of this approach to reform. Other countries, including developing countries such as Malaysia, have also concluded this kind of agreement. Peru has signed an open-skies agreement with the United States, although the agreement has not produced the expected results. A similar agreement with the Netherlands, on the other hand, is functioning properly and is providing Peru with opportunities in tourism and trade. Bolivia has concluded open-skies agreements with the other members of the Andean Pact and with Cuba.

65. There are at present 11 air transport initiatives at the regional level at various stages of development. These initiatives vary greatly, ranging from agreements already in force to mere plans of action for the future. The preliminary evaluation of the regional initiatives seems to be positive, and ICAO is viewing them with optimism as tools to achieve further liberalization of the sector. However, one expert at the Meeting stressed the risk that regional agreements might create trade barriers for third parties, who might find it difficult to extract concessions. Experience has shown that if a high political profile is given to the conclusion of a regional agreement, it has a greater chance of success. According to the ICAO definition, plurilateral agreements are agreements negotiated by certain countries which are open for accession by other countries.

66. The European Union's arrangements with regard to air transport were singled out by experts as the most sophisticated of the regional initiatives, but they are not yet complete. Arrangements in the sector are often related to broader economic integration schemes aimed at trade liberalization within the same economic space. Developing countries view the creation of regional integration in the sector as a way to improve their negotiating position in agreements reached on market access with developed countries. So far, in many instances members of the regional blocs have been negotiating fifth-freedom rights individually and not as a bloc. However, regional groupings could develop internal rules with respect to cabotage, which would not extend to routes negotiated bilaterally. In negotiating with third parties, it was the latter who often had problems accepting the framework of negotiations with a bloc on code-sharing, ownership and the like. Developing countries are seeking to proceed with further integration, as they believe such processes in the European Union have been excluding them and preventing their carriers from improving their share of that market. Countries in the Andean Pact are seeking to expand their open-skies agreement to third countries.

67. South Africa, Uganda and the United Republic of Tanzania set up a common regional airline in 1995 for the purpose of consolidating the market in the region and developing a regional hub. This regional alliance might consider joining larger alliances in the future. Being regional, it will probably be in a better position to negotiate the terms of its participation in a larger alliance. The three member countries of the alliance negotiate together, have a common strategy and speak with one voice. Eleven African States have united to create a single air space and have designated a single agency to conduct negotiations on their behalf. Such a grouping might have a more restrictive impact, since all third-country travel is treated as cabotage within it.

68. The Agreement of Fortaleza was concluded in 1997 by six South American countries. It applies only to those routes not covered by bilateral agreements, or to routes covered by bilateral agreements which lie dormant because the circumstances have changed or because the markets are too thin in terms of available traffic or are economically unviable to develop or operate.

69. Treatment of ownership has been evolving in the regional setting, where single ownership is becoming less important. Shared resources and joint ownership in the supply of services mean that the definition of ownership can be treated less rigidly in regional arrangements. If this trend continues, it will mean that the treatment of ownership might end up being less different from treatment in other services sectors. Liberalization of investment regimes and sharing of resources are the first steps towards evolution in the treatment of ownership. Safety issues remain important and could be addressed through the designation of a country of jurisdiction.

70. In formulating their agreed conclusions, experts decided they should be seen as a set of issues which would guide further work by member countries as they prepared for the negotiations on services. A number of speakers stressed the difficulties created by the transition from the current system, focused on ICAO, to a system of trade-related issues managed according to GATS principles. It was not yet clear what sorts of legal issues would arise, since a great deal of legislation was based on policy developed in ICAO processes. Further consideration of that question by legal experts would be helpful.

71. A related issue was what was described as the "institutional scramble". Many organizations and regional groupings, including WTO, UNCTAD, the Organisation for Economic Cooperation and Development (OECD) and the European Union, are taking an interest in air transport but are working separately. One view was that ICAO had to be the focal point for work on regulatory reform in this sector; ICAO would then have to bring in the trade elements. The role of UNCTAD also needed further thought and elaboration.

72. Experts also considered a variety of routes to reform. Some of them considered that one likely route would be an evolution from the restrictive bilateral agreements to more open arrangements within regional groupings, leading to the creation of multilateral structures. Routes to reform within the GATS framework were also discussed. One suggestion was to focus on modes of supply, and to stress those modes that were excluded and those that were included. Other experts drew attention to the value of focusing instead on subject areas, such as cargo.

73. Another idea put forward was to begin by developing trade in soft rights, which could be done by extending the coverage of paragraph 3 of the Annex. As a number of experts pointed out, however, that would require in the first instance a more elaborate definition of air transport activity. If that approach was to be pursued, the line had to be drawn between those services included in paragraph 2 of the Annex (the present wording refers to traffic rights and services related to traffic rights) and those not included.

74. Some participants argued that it would be premature to begin considering hard rights. Such an opening up of the market was described as "scary". Industry representatives noted the common concerns among airlines of being over-hasty but also recognized that the implications of such options would have to be considered analytically, in order to respond effectively to the review of the treatment of air transport in the GATS. Developing countries would have to articulate their concerns and introduce them into the debate.

75. If hard rights were to be considered, then transitional arrangements would also have to be discussed. In that context, the experts debated the relevance of GATS article IV, which refers

to the increasing participation of developing countries in trade in services. A statement was made on the value of a study of the implementation and effectiveness of that article.

76. Several experts reiterated the value of a focus on competition policy, arguing that liberalization that ignored competition policy issues would not work. At the same time, however, dealing with such issues would also require the strengthening of national competition policy institutions.

77. There was considerable discussion on the issue of exemptions from anti-competitive practices. Industry representatives believed that inter-firm cooperation in the industry provided important public benefits, such as those related to interlining. Other participants remained concerned about the implications of immunity from the application of anti-trust law. Such immunity was available in some cases in relation to alliance agreements, and was granted subject to the establishment by alliance members of offsetting public benefits – benefits which might offset any restrictive effects of the implementation of such agreements. In the view of some experts, States should be invited to consider establishing transitional periods for the elimination of sectoral exemptions to anti-competitive conduct in air transport which had effects in international markets. There was, however, no consensus on that matter. Such exemptions need to be carefully examined in the context of the application of competition policy to the industry, and it will be a particularly difficult challenge to deal with those exemptions that have effects across national borders.

78. With regard to the use of the Reference Paper on Basic Telecommunications as a model for managing competition policy issues in air transport, which was endorsed by the experts in their agreed conclusions (see section I above), the question was raised as to whether the linking of CRS was an example of the "access to infrastructure" set of issues mentioned in the paper. One view was that the use of CRS was a business practice issue, and that interlinking those systems was not critical for the presence of competitive markets. Another view was that such links were indeed critical and that there was a close analogy to the situation where telecommunications service suppliers needed to have access to the fixed-line network in order to enter the market. Clearly, the perception remains that important competition policy issues are involved in CRS ownership and control and that this is a topic for further empirical work.

III. ORGANIZATIONAL MATTERS

A. Convening of the Expert Meeting

79. In accordance with the recommendation made by the Commission on Trade in Goods and Services, and Commodities at the closing meeting of its third session, on 2 October 1998,[2] the Expert Meeting on Air Transport Services: Clarifying Issues to Define the Elements of the Positive Agenda of Developing Countries as regards both the GATS and Specific Sector Negotiations of Interest to Them was held at the Palais des Nations, Geneva, from 21 to 23 June 1999. The meeting was opened on 21 June by Mr. Rubens Ricupero, Secretary-General of UNCTAD.

B. Election of officers

(Agenda item 1)

80. At its opening meeting, the Expert Meeting elected the following officers to serve on its bureau:

Chairperson:	Mr. Christopher Findlay	(Australia)
Vice-Chairperson-cum-Rapporteur:	Mr. Mustapha Chaouki	(Tunisia)

C. Adoption of the agenda

(Agenda item 2)

81. Also at its opening plenary meeting, the Expert Meeting adopted the provisional agenda circulated in TD/B/COM.1/EM.9/1. Accordingly, the agenda for the Meeting was as follows:

1. Election of officers

2. Adoption of the agenda and organization of work

3. Clarifying issues on air transport services to define the elements of the positive agenda of developing countries as regards both the GATS and specific sector negotiations of interest to them

4. Adoption of the outcome of the Meeting

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[2] See Report of the Commission on Trade in Goods and Services, and Commodities on its third session (TD/B/45/10-TD/B/COM.1/22), paragraph 83 (c).

D. Documentation

82. For its consideration of the substantive agenda item (item 3), the Expert Meeting had before it a report by the UNCTAD secretariat entitled "Air transport services: the positive agenda for developing countries" (TD/B/COM.1/EM.9/2).

E. Adoption of the outcome of the Meeting

(Agenda item 4)

83. At its closing plenary Meeting, on 23 June 1999, the Expert Meeting adopted the agreed conclusions reproduced in section I, and authorized the Chairperson to prepare a summary of the informal discussions (see section II above).

Annex

ATTENDANCE*

1. Experts from the following States members of UNCTAD attended the Meeting:

Argentina
Australia
Bolivia
Brazil
Burkina Faso
Cameroon
Chile
China
Comoros
Côte d'Ivoire
Cuba
Dominican Republic
Egypt
Ethiopia
France
Guatemala
Guinea
India
Indonesia
Iran (Islamic Republic of)
Italy
Japan
Kenya
Libyan Arab Jamahiriya
Madagascar
Malawi
Mali
Mauritania
Mexico
Morocco
Namibia
Netherlands
Niger
Nigeria
Oman
Pakistan
Paraguay
Peru
Philippines
Russian Federation
Sri Lanka
Sudan
Switzerland
Thailand
Tunisia
Turkey
Turkmenistan
United Kingdom of Great Britain and Northern Ireland
United Republic of Tanzania
United States of America
Zimbabwe

2. The following intergovernmental organizations were represented at the Meeting:

African, Caribbean and Pacific Group of States
Arab Labour Organization
Economic Community of West African States
European Community
Organisation for Economic Co-operation and Development
South Centre
World Tourism Organization

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* For the list of participants, see TD/B/COM.1/EM.9/INF.1.

3. The following specialized agencies and related organization were represented at the Meeting:

International Labour Organization
International Civil Aviation Organization
International Monetary Fund
World Trade Organization

4. The Economic Commission for Africa and the International Trade Centre UNCTAD/WTO were represented at the Meeting.

5. The following non-governmental organizations were represented at the Meeting:

General Category

World Federation of United Nations Associations
World Vision International

Special Category

International Air Transport Association

6. The following organizations, specially invited by the secretariat, attended the Meeting:

African Airlines Association
International Federation of Airline Pilots Associations

Speakers

Mr. John Gunther, Chief, Economic Policy Section, International Civil Aviation Organization
Mr. Pierre J. Jeanniot, Director General, International Air Transport Association
Mr. Pierre Latrille, Counsellor, World Trade Organization
Mr. Renato Claudio Costa Pereira, Secretary-General, International Civil Aviation Organization

Special Guest

Mr. François Vellas, University of Toulouse, France

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TRADE AND DEVELOPMENT BOARD
Commission on Trade in Goods and Services, and Commodities

REPORT OF THE EXPERT MEETING ON THE IMPACT OF CHANGING SUPPLY-AND-DEMAND MARKET STRUCTURES ON COMMODITY PRICES AND EXPORTS OF MAJOR INTEREST TO DEVELOPING COUNTRIES

Held at the Palais des Nations, Geneva,
from 7 to 9 July 1999

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I. AGREED CONCLUSIONS [1]

1. A large number of actions and policies could help to enhance the benefits of commodity production and trade for developing countries. These policy conclusions and recommendations are grouped here in three areas: (a) policies with regard to the general state of the world commodity economy (which corresponds most closely to the traditional domain of international commodity policy discussions); (b) policies specific to improving the domestic framework for commodity sector production, processing and trade, specifically in the light of market liberalization (these fall under the responsibility of Governments, but international organizations can provide valuable assistance, including in facilitating the transfer of expertise and experience among countries); and (c) policies with regard to the "nuts and bolts" of international trade, where certain conditions are necessary before developing countries can really benefit from globalization (an area where international support will in many cases be necessary).

A. The general state of the world commodity economy

1. Improving the transparency of international commodity markets

2. Information is crucial in international commodity trade. Information is a powerful tool, and highly relevant for smaller producers, and for commodities for which there are no organized futures markets or other mechanisms for ensuring price discovery and transparency. There are four basic approaches to improving information flows: (a) enhance the possibilities for those involved in commodity production and trade and, if they wish, commodity consumption, to exchange experience and ideas; (b) stimulate the development of publicly accessible "clearing houses" for international commodity sector information (prices, stock levels, etc.); (c) encourage more efficient dissemination and use of information; and (d) do research on questions about which little is known.

3. Given the natural information advantage of the large multinational companies, developing country producers and others involved in the commodity sector have an interest in a regular exchange of experience, with the backing, where relevant, of their Governments and international organizations through entities such as international commodity organizations and international study groups.

4. Such groups could go further than just discussing markets; they could actually act as focal points for the discussion of new sanitary and phytosanitary and product identification policies. For example, tightening standards are common for much of commodity trade. However, the new standards are far from uniform across countries, which causes additional costs, particularly to developing country producers, and may even become non-tariff barriers. There is a need for a mechanism whereby common industry standards (including for product labelling) for specific product imports can be adopted, and this is perhaps a role that could be taken on by such international commodity bodies.

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[1] As adopted by the Expert Meeting at its closing plenary meeting on 9 July 1999.

5. Apart from stimulating the exchange of experience and information as described above, there is a general role for organizations such as UNCTAD and the International Trade Centre UNCTAD/WTO, as well as the Common Fund for Commodities, international commodity bodies working on specific commodities and other international and regional organizations, to promote market transparency. Such efforts need to be strengthened, and merit more support from the international donor community. In this regard, due consideration should be given to making access to information affordable, in particular for the least developed countries.

6. More work is needed to ensure the efficient dissemination of information, and to provide the necessary training for users of such information to make good use of it.

7. As regards research, information on price formation at several levels of the marketing chain suggests that competition does not always work properly in the commodity sector. This would seem a priority area for research to be done by UNCTAD (and other interested parties), in particular to determine which parts of the distribution and marketing chain are absorbing margin increases and why, and, if anomalies are found, to identify possible policies to deal with this. Such research should encompass not only commodity markets, but also the markets for key inputs into commodity production, for example, one can note the increasing concentration among seed-producing companies.

2. Tackling the issues of tariff and non-tariff measures, and commodity sector subsidies

8. Non-tariff measures and subsidies in developed countries continue to be a problem for developing country agriculture. A commitment should be made at the forthcoming World Trade Organization (WTO) Ministerial Conference for the elimination of these subsidies as agreed in the Uruguay Round, and ensure that the non-tariff measures allowed under the Uruguay Round do not act as barriers to international trade.

3. Improving the management of the commodity sector

9. While world markets are of course important, Governments and the private sector should not lose sight of the often interesting opportunities that exist for commodity production and trade at the national and regional level.

10. Many developing country Governments lack clear information on which policies to adopt, given past experiences of other countries. This applies to issues related to the "infant industry" argument for the commodity sector, and to food security. There is a need for more research on these issues, with the objective of analysing national experiences in this regard, evaluating the effects of a greater dependency on international food markets, and formulating general principles for national policies. In many cases, an international agency could help in familiarizing Governments with possible policy options and their implications.

11. In some cases, policies which are in principle external to the commodity sector nevertheless have a large influence. For example, government taxes on commodity trade often have perverse effects, such as discouraging production or processing and stimulating smuggling. An inventory of national experiences and the formulation of policy guidelines on effective legal and regulatory frameworks, including commodity trade taxation policies, would be useful.

12. Much of the development of the commodity sector requires considerable finance, and in this respect, Governments should make efforts to attract capital to their commodity sectors; such efforts would then also stimulate the repatriation of the country's export earnings.

4. Enhancing the international market potential of the commodity sector

13. The international market potential of certain commodities is underexploited, and there are possibilities for growth. For example, technology does not just lead to the replacement of commodities by synthetic substitutes, but can also create new markets for commodities, as in the building industry or in geo-textiles. There is a need to support research which leads to such new end-uses, and to promote such new uses.

14. Diversification, into the production and exports of new commodities and into commodity processing as well as outside the commodity sector, should be pursued and encouraged as a viable strategy for reducing commodity dependence and maximizing socio-economic gains. Expanding the export base, value addition to commodity producers, valorization of by-products and the promotion of investment in this sector would require support in the form of technical and financial assistance from the international community.

15. The Common Fund for Commodities, being a major financier of commodity development activities, should continue to support research and development for promoting diversification and improvements in productivity and competitiveness. It should also continue to stimulate the creation of new demand outlets for developing country products, new end-uses, development and marketing of premium-quality products and promotion of investments in commodity development technologies.

16. There is also definite potential for brand-name products in national, regional and international markets. However, it is not clear what the most efficient way is to promote brands, that is, whether generic promotion or the promotion of country or specific brands is more efficient. It would be useful if an organization such as UNCTAD reviewed the importance of brand names, and the experiences of and in developing countries to promote them. Support should then be given to implementing the conclusions of such work.

5. Coping with international market shocks

17. Commodity sectors are increasingly vulnerable to international price shocks – this applies to both exporting and importing sectors, and even to those producing for the domestic market. Commodity producers worldwide have become exposed to fluctuations in currency markets. Apart from general policies to strengthen the financial system as a whole, specific preventive measures can be taken in the commodity sector to reduce the negative effects of financial crises.

18. Such shocks generally have a double impact on commodity producers in developing countries: first, world prices fall, often by more than would have been the case in a competitive world market because developed country producers are shielded from price falls through subsidies; and, second, financing costs become prohibitive. Thus, the severity of international crises for developing country commodity producers would be less if international commodity

markets were less distorted and if local financial institutions were better equipped to provide low-cost commodity finance (warehouse receipt finance and other forms of structured finance).

19. Governments should be given the leeway by international donor agencies to take the necessary measures to protect crucial sectors from the effects of international shocks. Moreover, they may be allowed temporary waivers from the commitments made under WTO.

20. Price instability is a fact of life, and while the extremes of such instability can be reduced by strengthening national economic systems and international cooperation, it should be realized that buyers and sellers have to take into account their expectations for future price developments when buying and selling, and when fixing prices through other means (including price risk management). What is needed is the empowerment of buyers and sellers so that they can optimize their choices and decisions. This implies, in particular, that their capacity to use price risk management markets has to be reinforced. UNCTAD, as well as the World Bank, has been active in this area for a long time, and the Common Fund for Commodities is starting projects in this field, but the strengthening of such international efforts is desirable.

21. The Common Fund for Commodities should strengthen and expand its assistance for the development of commodity markets in developing countries. Its support may focus, in particular, on physical market development, the promotion of commodity exchanges, and the enhancement of market infrastructure and support services, all with a view to stimulating private sector initiative and participation in commodity marketing.

22. Commodity-dependent developing countries are highly vulnerable to price volatility, and in this light, schemes such as STABEX (Système de stabilisation des recettes d'exportation) to compensate exporters (and in particular, the least developed among them) for loss of export earnings were deemed useful. However, ways to make such schemes more effective should be explored.

B. Creating efficient local markets in a liberalized environment

23. In the light of the penetration by international trade houses and other multinational companies into procurement and distribution activities in developing countries' domestic commodity markets, efforts need to be made to ensure that local farmers, processors and traders are in a position to participate equitably in these markets, for example by improving their access to essential services such as credit.

24. When liberalizing, it is advisable to do so gradually, and to ensure that the local private sector is able to take on new functions. Moreover, it is very difficult for producers from developing countries to compete, in an environment devoid of government support and protection, with highly subsidized farmers from developed countries. This has implications for the liberalization process: before fully opening up critical sectors to world market competition, developing country Governments need to have the time to strengthen their domestic commodity sectors. The measures involved are often quite straightforward, although there are evidently budgetary implications. Simple technologies can often make a big difference in the ability of producers to produce goods for the market place and to get them there. New tools like the Internet should not distract attention from the need to stimulate the basic development of the

physical market place, including through the spread of such simple technologies. Such actions could also help smaller players to continue competing with larger ones, who are otherwise more able to benefit from the advances in technology. For this, they need to be provided with international technical and financial assistance.

25. Once a liberalization programme has started, there is a need to accompany it with:

(a) Training and awareness-raising programmes for the private sector, including banks, on the basics of commodity trading (including quality aspects) and finance; and

(b) Institution-building, for cooperatives, traders and banks.

26. As a result of liberalization, farmers and consumers are often fully exposed to world market price instability. There is a need to explore the possibilities of market-based safety-net approaches (where Governments take the responsibility for providing the safety net, but lay off much of their risks in the market) both for export-oriented sectors and for the protection of low-income consumers.

27. After the withdrawal of the Government from commodity marketing, there has been a disruption in many countries in the supply of basic technology, extension services and inputs to farmers, quality control services, warehousing and transport, risk management, financing and market intelligence. To overcome this problem, the international community should assist Governments in:

(a) Identifying and promoting new models under which the private sector can provide such services, and undertake awareness-raising and training on these models; and

(b) Ensuring that such services continue to be provided to farmers until the private sector has built up its capacity to provide them, for example through the creation of new business-oriented government facilities.

28. With regard to both international and domestic markets (including the local marketing of exported or imported crops), in countries where Governments are getting out of commodity pricing and commodity trade, there is generally a need to support the emergence of new pricing and trading mechanisms, in order to ensure a transparent market place. In many (but not all) cases, the development of commodity exchanges of various kinds (trading physical commodities and/or forward or futures contracts, using a physical auction site or electronic means) can provide strong support for the creation of an efficient physical market place. The international community can support such efforts by providing policy advice to Governments on the opportunities afforded by commodity exchanges in a liberalized agricultural environment and on relevant regulatory structures, by providing training for exchange managers and potential exchange users, and by stimulating the exchange of experiences between country regulators and between exchanges.

29. Improving information and communication flows, when complemented with mechanisms that allow producers to respond effectively, is one of the most effective ways of strengthening the

market power of smaller actors, as exemplified by the recent experience of the National Food Authority in the Philippines regarding trade in maize. In this respect, there is a need for:

(a) Research on country experiences regarding the impact of information and communication systems on the marketing possibilities and marketing power of farmers and small traders;

(b) The formulation of policy models to enhance the use of such systems;

(c) Awareness-raising and training on these issues; and

(d) Financial support for the establishment of new networks.

30. Financing bottlenecks are often very important. Local banks in many, if not most, developing countries charge real interest rates and are often unfamiliar with agricultural lending. This makes exporters and local traders dependent on foreign buyers. In this area, there is a need for:

(a) Awareness-raising and training on financing schemes for the commodity sector, focused on banks as well as commodity-sector actors;

(b) The development of efficient warehouse receipt systems;

(c) The creation of linkages between local agricultural and financial markets; and

(d) The improvement of laws and regulations affecting commodity finance.

There is a case to be made for the strengthening of international institutional arrangements for support in this area (as well as in the related area of commodity price risk management), and UNCTAD and other international organizations are urged to explore the possibilities in this area.

31. Strengthening farmers' associations can be effective in enabling farmers to get access to information and credit, enhance their marketing power, improve their trading logistics and obtain access to risk management markets.

32. Regional economic groupings are important for allowing the development of regional trade, thus enabling economies of scale in freight and reducing transport costs, improving information flows and rationalizing quality standards. This would help to build sufficiently strong structures to perform properly in a globalized and liberalized environment.

C. Adapting to and realizing opportunities arising from international commodity market conditions

33. The international commodity market offers opportunities, but these opportunities cannot easily be realized by exporters from developing countries, who are often undercapitalized. This underlines the need for strengthening the access of developing country exporters, in particular those from the least developed countries, to finance markets. The international community should

provide support in this matter, including through the development of new commodity financing mechanisms.

34. One important problem area is that of meeting new sanitary and phytosanitary requirements as well as the Hazard Analysis Critical Control Point conditions. Whereas companies in developed countries often have access to the required resources, it can be difficult for developing country companies to adapt to such requirements, as they have to find the necessary funds themselves. In this area, there is a need for training and awareness-raising, exchange of experience and financial support.

35. Companies from developing countries can in many cases benefit from linkages with international companies in their bid to acquire the necessary technology, skills and systems; such linkages can also act as a stepping stone for new exports.

36. Producers cannot always exploit growing consumer demand for high-quality products because transport costs for such products tend to be high, and because intermediaries often absorb much of the quality premium. In effect, such intermediaries can even use tightening consumer demands as a tool to extract high quality for relatively low prices from producers. This suggests that it would be useful to create a mechanism whereby producers are more correctly informed about consumer demands in terms of premiums paid for quality.

37. South–South trade is growing, but it is often done by trading houses from the North, with finance passing through developed country banks. Efforts need to be made to develop the capacity of traders and banks in the exporting and importing countries to handle South–South trade by themselves. Training, awareness-raising and institution-building (particularly for banks) are essential for enabling developing countries to draw greater benefits from South–South trade. South–South trade could be further expanded with more regular meetings between buyers and sellers.

38. The physical infrastructure for trade (ports, roads, pipelines and handling facilities) is inadequate in many countries, resulting in costly and inefficient transport. Governments need to accept a greater role for the private sector in the provision of such infrastructure. Moreover, multilateral financial support for infrastructure is needed, as well as the promotion of a greater understanding of structured financing tools, and enhancement of the ability to use such tools.

39. Many developing countries spend a major part of their export earnings on commodity imports. Possible measures to reduce the costs of such imports include: improvements in the policy, legal and regulatory frameworks; stimulating the awareness and understanding by importers of international market conditions and systems; and improving access to finance (including through structured commodity finance).

40. In many countries, financing costs are not related as much to company risk as to sovereign risk, and the assessment of the latter is often subjective. UNCTAD could create more awareness among policy makers from developing countries of the determinants of sovereign risk, in order to allow them to try and improve their country's risk rating.

II. ORGANIZATIONAL MATTERS

A. Convening of the Expert Meeting

41. In accordance with the recommendation made by the Commission on Trade in Goods and Services, and Commodities at the closing meeting of its third session, on 2 October 1998,[2] the Expert Meeting on the Impact of Changing Supply-and-Demand Market Structures on Commodity Prices and Exports of Major Interest to Developing Countries was held at the Palais des Nations, Geneva, from 7 to 9 July 1999. The meeting was opened on 7 July by Mr. John Cuddy, Director of the Division on International Trade in Goods and Services, and Commodities.

B. Election of officers

(Agenda item 1)

42. At its opening meeting, the Expert Meeting elected the following officers to serve on its bureau:

Chairperson:	Mr. David Hew	(Singapore)
Vice-Chairperson-cum-Rapporteur:	Mr. W.A. Bastiaanse	(Netherlands)

C. Adoption of the agenda

(Agenda item 2)

43. Also at its opening plenary meeting, the Expert Meeting adopted the provisional agenda circulated in TD/B/COM.1/EM.10/1. Accordingly, the agenda for the Meeting was as follows:

1. Election of officers.

2. Adoption of the agenda.

3. Impact of changing supply-and-demand market structures on commodity prices and exports of major interest to developing countries.

4. Adoption of the outcome of the Meeting.

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[2] See Report of the Commission on Trade in Goods and Services, and Commodities on its third session (TD/B/45/10-TD/B/COM.1/22), paragraph 83 (a).

D. Documentation

44. For its consideration of the substantive agenda item (item 3), the Expert Meeting had before it a report by the UNCTAD secretariat entitled "The impact of changing supply-and-demand market structures on commodity prices and exports of major interest to developing countries" (TD/B/COM 1/EM 10/2).

E. Adoption of the outcome of the Meeting

(Agenda item 4)

45. At its closing plenary meeting, on 9 July 1999, the Expert Meeting adopted the agreed conclusions reproduced in section I.

Annex

ATTENDANCE

1. Experts from the following States members of UNCTAD, attended the meeting:

Algeria
Bangladesh
Belarus
Bolivia
Brazil
Bulgaria
Burkina Faso
Cameroon
Canada
Chile
Colombia
Côte d'Ivoire
Czech Republic
Democratic Republic of the Congo
Dominican Republic
Ecuador
Ethiopia
Finland
France
Gambia
Germany
Guatemala
Guinea
Haiti
Honduras
India
Indonesia
Iran (Islamic Republic of)
Iraq
Italy
Jamaica
Lebanon
Libyan Arab Jamahiriya
Madagascar
Malaysia
Mali
Mauritania
Mexico
Mongolia
Morocco
Mozambique
Netherlands
Nicaragua
Niger
Pakistan
Panama
Peru
Philippines
Republic of Korea
Russian Federation
Saint Lucia
Senegal
Sierra Leone
Singapore
South Africa
Spain
Sudan
Suriname
Sweden
Switzerland
Tunisia
Turkey
Turkmenistan
Uganda
Venezuela
Zimbabwe

2. The following intergovernmental organizations were represented at the meeting:

Arab Labour Organization
Common Fund for Commodities
Economic Community of the Great Lakes Countries
International Coffee Organization

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* For the list of participants, see TD/B/COM.1/EM.10/INF.1.

International Jute Organization
International Tropical Timber Organization
Organisation for Economic Co-operation and Development
South Centre

3. The following specialized agency and related organization were represented at the meeting:

Food and Agriculture Organization of the United Nations
World Trade Organization

4. The International Trade Centre UNCTAD/WTO was represented at the meeting.

5. The following non-governmental organizations were represented at the meeting:

General category

International Confederation of Free Trade Unions
World Federation of United Nations Associations

Special category

International Council of Nurses
Professional Association of Natural Rubber in Africa

6. The following people also participated in the meeting:

Resource persons

Mr. Luis Carlos Delanoe
Mr. James Gachui
Mr. Tan Seng Hock
Mr. H. Tarmidzi Rangkuti
Mr. Thiombino Taladidia
Mr. Roland Wiefels
Mr. El Hadj Amadou Wone
Mr. Philippe Chalmin
Mr. Dominique de Guerre
Ms. Claudine Ndayikengurutse
Mr. A. Belozertsev

Other participant

Mr. André Marie Roger SOUMAH, Executive Chairman, ACE Audit Control and Expertise

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THE WORLD COMMODITY ECONOMY: RECENT EVOLUTION, FINANCIAL CRISES, AND CHANGING MARKET STRUCTURES

Report by the UNCTAD secretariat

Executive summary

The importance of commodities in world trade is declining and developing countries are losing their share in world commodity trade, particularly in dynamic, high-value agricultural products and processed items. Massive agricultural support in developed countries has been an important factor in this respect. The loss in shares is especially marked for African, least developed and ACP countries. The historically extremely low prices for commodities aggravate the negative impact of these losses on the economies of commodity-dependent countries. Increasing yields have not counterbalanced these impacts for agricultural products. Moreover, the margins between international prices for commodities and consumer prices are widening. In metals and minerals, cost reductions have been substantial.

Recent financial crises have reduced the demand for commodities in South-East Asia. At the same time, supplies of several commodities from the region have increased. There has been a significant depressing impact on the commodity markets, somewhat mitigated by strong demand in developed countries. More recently, economic problems in Brazil generated downward pressure on prices. In all crisis-stricken countries, however, following currency depreciations, the commodity sector has performed considerably better than other parts of the economy. These devaluations have been a principal vector of contagion.

The concentration on the demand side of world commodity markets is continuing, while state participation in developing countries' agricultural sectors is radically reduced. Mainly as a result of the latter, the domestic provision of some crucial services has been hampered and purchasing firms with large financial resources have been able to penetrate deep into the marketing and production structures in developing countries. Although this opens up opportunities for export-oriented enterprises in developing countries, it also generates important new challenges for them.

Policy proposals include the elimination of agricultural support and protectionism in developed countries, measures to make the international markets more competitive, filling the void in developing countries created by the withdrawal of the State from the commodity sector, improved skills in the enterprise sector of these countries, and renewed producer consumer dialogue which involves all stakeholders.

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I. INTRODUCTION

1. The longstanding problems faced by the world commodity economy have been analysed by UNCTAD and others many times in the past and discussed at length in various intergovernmental forums, including UNCTAD. These problems persist and have in fact become more serious over time. The long-term declining terms of trade, price instability, and institutional factors emanating from economic policies, such as agricultural subsidies and trade barriers, have been exacerbated by the effects of financial crises. Significant changes in the distribution and market structures are also becoming increasingly important in determining the success or failure of the commodity sector as an engine of development, particularly in commodity-dependent developing countries.

2. In this report, in view of the page limitation, rather than making an exhaustive but superficial review of the factors behind the commodity situation, an attempt has been made to identify and analyse in some depth some of the principal issues currently affecting commodity-exporting developing countries. In Chapter II, an overview of the evolution of world commodity trade since the 1970s emphasizes the loss of market shares by developing countries, in particular African and least developed countries (LDCs). The impact of agricultural support policies in developed countries is also underlined. In Chapter III, information is provided on the declining trend and current collapse of commodity prices, and in this context reference is made to increasing productivity in both agriculture and metals and minerals. In Chapter IV, in order to understand better the current commodity situation, the implications of recent crises on both the supply and demand sides are briefly analysed, focusing particularly on the impact of devaluations and the links between financial and commodity markets. Chapter V reviews the changes in distribution and market structures, emphasizing the twin trends of concentration in global markets and liberalization in producing countries, and examines the impact of these trends on commodity exporting-countries. Some policy proposals are offered in the final chapter.

II. THE EVOLUTION OF THE WORLD COMMODITY ECONOMY

A. Global commodity trade and consumption

3. Over the last three decades the share of non-fuel commodities in world trade has been declining. It dropped from 25.5 per cent in 1970-1972 to 18.1 per cent in 1980-1982, the steepness of the drop reflecting the sharp rise in the relative price of petroleum. Since the early 1980s, it dropped further, reaching 14.1 per cent in 1996-1997. Between 1980 and 1995, world trade in agricultural products grew, in value terms, at 4.7 per cent per year, and world trade in mineral commodities at 4 per cent, both considerably slower than the growth in trade of manufactured products, which was 8.6 per cent.

4. The decline in relative prices of commodities and a "double counting" of manufactures trade have both contributed to the difference in growth rates of trade between commodities and manufactures. As manufacturing has become more international over the years, and different stages of processing increasingly take place in different countries, the "double counting" of manufactures trade has increased, reducing misleadingly the relative importance of commodities[1]. Moreover, an

[1] For instance, exported cars are often assembled from imported parts. Some of these parts may, in turn, have been assembled from imported pieces. The shares of cars, motor vehicle parts and internal combustion engines in international trade are, respectively, 5 per cent, 2.5 per cent, and 1 per cent. Simply adding these up exaggerates the relative importance of car related items, and consequently reduces that of other products such as commodities for which such double counting is much

important characteristic of the commodity sector is the relatively high proportion of value added which is created domestically in this sector, compared with other economic activities that are much more dependent on imported inputs. Thus the contribution to the economy of a dollar earned through commodity exports, particularly in processed forms, is likely to be higher than that earned through manufactured exports using imported inputs. These factors, together with the strong dependence of a large number of developing countries on this sector for the generation of foreign exchange and savings necessary for development, render the importance of commodity trade to development higher than is apparent in world trade figures.

5. Developments differ significantly between commodity subsectors, with some showing a more positive consumption growth and trade performance than others. In this connection, the impact of changes in the composition of demand is particularly evident for food commodities. In developed countries, the consumption and trade of high-value products such as fresh fruit and vegetables, many kinds of processed foods, in particular "convenience foods", and certain niche items, such as organically grown products, is rapidly increasing. For example, the proliferation of chocolate containing snacks has been a crucial factor behind the relatively fast growth of demand for cocoa. In developing countries as well, as incomes grow, the pattern of food consumption changes, increasing the demand for a different group of "high-value" products such as vegetable oils and meat, for which demand in the industrialized countries is stagnating. In the past 25 years, for all developing countries combined, per capita consumption of meat, eggs and milk has risen by about 50 per cent per person. It remains, however, still at about one quarter of the developed world average[2], indicating the consumption potential that exists, not only for meat but also for all sorts of commodity-based feedstuffs, such as grains and oil cakes. Considering raw materials, competition from synthetics and composite materials is a restraining factor for growth in demand, although some commodities have favourable natural qualities that give them a competitive edge over substitutes.

6. Demand for minerals and metals is determined by the raw material needs of industrial production and construction activities. However, the relationship is not entirely stable and is affected by the product composition of output as well as by changes in technology and the prices of other inputs to the production process. Thus, as a result of the increases in energy prices in the 1970s the mineral intensity of manufacturing declined significantly in the 1970s and 1980s. In contrast, during the 1990s, commodity intensity of GDP for major metals has been roughly constant according to most estimates[3]. This means that global demand for metals has grown at a rate about equal to that of world GDP. The rate of recycling, however, has increased during the same period, and consequently, the demand for primary metals has grown at a slightly lower rate[4].

B. Developing countries in world commodity production and trade

7. During the 1970s and 1980s the shares of developing countries in world exports of commodities declined. Based on three-year averages, their (excluding China and the former Soviet Union) share, which was 31.5 per cent in 1970-1972, fell to 25.4 per cent in 1990-1992, to rebound

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less significant.

[2] IFPRI, "Are we ready for a meat revolution?", *News & Views*, March 1999, p. 6.

[3] See Crowson, P. *Inside Mining*, Journal Books, London 1998, for a longer perspective on intensity of use for metals.

[4] The increase in the rate of recycling has been most striking for lead, where the proportion of refined production coming from scrap increased from 30 per cent in 1976 to 48 per cent in 1997, and for aluminium, where the proportion of recycled material in production rose from under 18 per cent to 25 per cent over the same period (World Bureau of Metal Statistics, *World Metal Statistics*, various issues).

somewhat in the 1990s to 27.4 per cent (statistical annex, Table 1). The pattern was similar both for agricultural products and for metals and minerals. For some groups of countries, such as Africa as a whole, Sub-saharan Africa; African, Pacific and Caribbean (ACP) countries; and LDCs, however, there was no rebound and the decline was particularly sharp. For example, LDCs' share in world commodity exports declined from 4.7 per cent in 1970-1972 to 1.2 per cent in 1996-1997. If the same shares were maintained as in 1970-1972 (and abstracting from any impact this might have had on prices), Africa's average annual export earnings in the period 1996-997 would have been $41.5 billion higher than what it was. For the LDCs, the difference would have been $26 billion.

8. In the same period, developing countries' share in world imports of food items declined marginally, but their shares, particularly of Asian developing countries, in imports of agricultural raw materials, metals and minerals, and fuels increased sharply. Only Latin America and Sub-saharan Africa still have significant surpluses on their non-fuel commodity trade balance. Several developing countries, particularly in Africa, continue to be highly dependent on food imports and their dependence has even increased.

1. Agriculture

9. In agriculture, production grew faster in developing than developed countries[5]. Much of the increased production in the former was domestically consumed, however, while that in the latter was mostly directed to export markets. This is one of the principal factors behind the decline in developing countries' share in world agricultural exports from 31.7 per cent in 1970-1972 to 25.4 per cent in 1990-1992. By 1996-1997, it had increased again to 30.7 per cent, a figure, nevertheless, smaller than 25 years earlier (statistical annex, Table 2).

10. There is a significant divergence in the experiences of different regions. The share of Africa in world exports declined dramatically for food items as well as agricultural raw materials, while Asia increased its share for food items, and developing America, for agricultural raw materials. For items for which the shares of developing countries have increased significantly, this can often be attributed to a large surge in the exports of a few countries where an important push has been undertaken. Examples include exports of poultry by Brazil, vegetable oils by Malaysia and Indonesia, and rice by Viet Nam.

11. Developed countries gained much ground as a result of massive subsidies provided to their producers and exporters, and also captured the bulk of the rapidly growing trade in processed products. Recently, it is in this latter area that growth has been particularly impressive. Between 1980 and 1996, the annual growth of exports by Organisation for Economic Cooperation and Development (OECD) countries of primary agricultural commodities and processed agricultural products was, respectively, 2.5 per cent and 6.5 per cent[6]. The latter group of high value-added items includes products requiring significant blending, processing and marketing activities, in particular marketing under brand names[7]. These are the products with more dynamic markets in recent years. Regarding

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[5] World Bank, *World Development Report*, various editions.

[6] OECD, *Agricultural Policies in OECD Countries, Monitoring and Evaluation, 1999*, Paris, 1999, p. 34.

[7] It is not only in processed products that most of the value added is created at the latter stages of the product chain. Studies on the distribution of revenues in the market chain for fresh products indicate that most of the value added until the product reaches the consumer is created after the product leaves the farm, in particular at the wholesale or retail stages. For example, in 1994, "US shoppers spent an average of $3.99 per pound on snow peas, and producers in Guatemala received about 18

tropical beverages, for example, developing countries' share in world exports (of raw and processed forms) declined from close to 85 per cent in the early 1970s to about 55 per cent in the early 1990s. Over the past 15 years, Germany's share in world coffee exports has risen from about 1 per cent to about 5 per cent, and in tea exports its share, which was less than one half per cent, has increased five times. A similar development can be observed for spices. The share of the European Union (EU) which used to be around 10 per cent in the early 1980s has now surpassed 15 per cent.

12. A brief review of the cocoa sector illustrates this situation. The share of cocoa-producing countries in world exports declines as the stage of processing increases. In 1997-1998, for cocoa beans, cocoa liquor, cocoa butter, cocoa powder and chocolate, the shares of these countries were, respectively, 90 per cent, 44 per cent, 38 per cent, 29 per cent and 4 per cent (statistical annex, Table 3). Moreover, over a 15-year period, the shares of these countries in world exports at all stages of processing have declined. Regarding the most lucrative stage of the cocoa product chain, namely, chocolate, in the 1990s, developed countries have increased the quantity of their exports much faster than that of imports (statistical annex, Table 4). There has, however, been a recent increase in the share of developing countries in world chocolate exports, accounted for by a recovery of exports from Côte d'Ivoire and Mexico and by relatively new entrants into the market, such as Indonesia and the Philippines. Nevertheless, his has merely brought the developing countries' share back to the meagre 4 per cent of the world market which they held in the mid-1980s.

13. Liberalization of agriculture pursuant to the Uruguay Round could be expected to reinforce the recent increase in the shares of developing countries in world agricultural exports. Despite the fact that four years have elapsed since the conclusion of the Uruguay Round, however, agricultural support measures in developed countries, which have been instrumental in their increased shares in agricultural exports and had detrimental impacts on developing countries, have not declined. "Uruguay Round disciplines were not a constraint for most OECD countries ... since ... the current Total Aggregate Measure of Support was well below Uruguay Round commitment levels"[8]. It is also very likely that these subsidies have contributed to the slowness of producers' response to price falls in recent crises.

14. In 1998, in the 24 original OECD countries (i.e. excluding Czech Republic, Hungary, Republic of Korea, Mexico and Poland), total agricultural support[9] amounted to about $335 billion, producer support to $251 billion (statistical annex, Table 5). This makes total agricultural support more than three times the official development assistance (ODA) flows and more than twice the foreign direct investment (FDI) flows to developing countries in 1998, and almost 60 per cent of total world agricultural trade in 1997. About 52 per cent of the producer support in the OECD is given by the EU (up from 45 per cent in 1986-1988). On average, farmers in Switzerland received about $33,000 of producer support in 1998. Farmers in the EU, Japan and the United States received around $20,000 as an average. Support provided to some products which are also exported by developing countries is many times the value of world trade in these items. For example, in 1997, in

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cents per pound, for mangoes, the US consumer spent 99 cents per pound, and the producer received about 8 cents". Thrupp, L. A. *Bittersweet Harvests for Global Supermarkets: Challenges to Latin America's Agricultural Export Boom*, World Resources Institute, Washington, 1995, pp. 77-81.

[8] OECD, *op. cit.*, pp. 43-44.

[9] Total support is "the annual monetary value of all gross transfers from taxpayers and consumers arising from policy measures which support agriculture, net of associated budgetary receipts", and producer support is "the annual monetary value of gross transfers from consumers and taxpayers to agricultural producers, measured at farmgate level, arising from policy measures regardless of their nature, objectives or impacts on farm production and income". OECD, *ibid.*, p. 271.

the 24 OECD countries, producer support to rice and meat was, respectively, 4.11 and 6.18 times the value of world exports of these products.

15. Another support measure which acts as a constraint on expansion of exports by developing countries is the minimum import prices used by the EU for the fruit and vegetable sector. Apples, mandarins, lemons, tomatoes, cucumbers and courgettes are subject to such arrangements all year, and various other products of export interest to developing and other countries for specified periods. "Although these ... have not been challenged within the WTO, ... it is difficult to believe that they will escape unchallenged in the Millennium Round."[10]

Box 1

Subsidized exports and West African tomatoes

After the United States and before Turkey, the world's second largest producer of tomato concentrate is the EU. Its tomato farmers are paid a minimum price higher than the world market price, which stimulates production. The processors, in turn, are paid a subsidy to cover the difference between domestic and world prices. In 1997, this subsidy is reported to have reached about $300 million. The processors, then, need to find markets, and about 20 per cent of exports go to West Africa. In recent years, about 80 per cent of regional demand in this region has been covered by tomato products from the EU, which are cheaper than local supplies. Stiff competition from EU industries has led to the closure of tomato processing plants in several West African countries.

In Senegal, for instance, tomato cultivation was introduced in the 1970s, and progressively acquired an important position for farmers, for whom tomato production was synonymous with a key opportunity to diversify their farming systems and stabilize incomes. In 1990-1991, production of tomato concentrate was 73,000 tons, and Senegal exported concentrate to its neighbours. Over the past seven years, total production fell to less than 20,000 tons. One of the main reasons for this dramatic fall was the liberalization of tomato concentrate imports in 1994. Despite the positive impetus provided by the devaluation of the CFA franc, the tomato processing industry could not compete with EU exporters. From 1995 on, exports to Senegal grew considerably, as shown by the following table.

	1993	1994	1995	1996	1997
Tons	381	62	5130	5348	3795
Million US$	0.3	0.1	4.8	3.8	3.0

SOCAS, the one Senegalese processing firm that has survived, buys imported triple concentrate and processes it into double concentrate. Other West African countries such as Burkina Faso, Mali and Ghana have had similar experiences of enormous increases in imports of EU tomato concentrates. Gambia, small as it is, imports even more tomato concentrate than Senegal, and consumption of concentrate is increasingly replacing that of fresh tomatoes. Ghana, which used to have three tomato processing plants in the early 1980s, has now become Africa's largest importer of EU tomato concentrate.

The lack of credit, and low prices, have contributed to the stagnation of West African tomato processing industries. If there is to be any hope of competitiveness, factories in the region will need new machines and massive investments. Foreign investment could be one option, but these factories would not interest potential foreign investors as long as the European products take over the local markets.

Source: Eurostep Dossier on CAP and Coherence, Euorostat.

2. Minerals, ores and metals

16. Regarding ores and minerals, the rebound in world export shares of developing countries during the 1990s can be attributed to a rapid increase in developing countries' (except Africa's) share of world production in the 1990s, mainly as a result of an expansion of foreign investment,

[10] Swinbank, A., K. Jordan and N. Beard, "Implications for Developing Countries of Likely Reforms of the Common Agricultural Policy of the European Union", report prepared for the Economic Affairs Division of the Commonwealth Secretariat, January 1999.

particularly in Latin America. From 1990 to 1995, the share of developing countries in the value of total non-fuel mineral production at the mining stage increased from 46.6 per cent to 55.2 per cent. The increase was particularly rapid for metals, including gold. The increase can be expected to continue, since exploration, which is a good indicator of future mineral investment and production, has shifted geographically from developed to developing countries. While in 1991, three developed countries (Australia, Canada and the United States) accounted for 61 per cent of exploration spending by large mining companies and Africa, Latin America and developing countries in the South-east Asia/Pacific region for 35 per cent, by 1998 the proportions had changed to 37 per cent and 56 per cent, respectively[11]. Developing countries have also been able to increase their share of world production of refined metals, which has grown steadily for several decades and is approaching their share for unprocessed minerals[12]. The increase in the production share of developing countries for minerals and metals illustrates how these countries have been able to use their comparative advantage, unlike agriculture where subsidies and other support policies generate monumental distortions that limit developing countries' ability to enter many markets. Due to increased processing in developing countries, both of ores to metals and of metals into semi-fabricated products, the share of these countries in world exports of unprocessed forms has increased less than that in production.

III. COMMODITY PRICES

17. Commodity prices have two characteristics that set them apart from the prices of manufactured goods: they decline over time in real terms and they fluctuate significantly. This Chapter focuses on the decline over time. Recent price fluctuations will be examined in Chapter IV, in the context of the implications of financial crises on commodity markets. Suffice it to say at this stage that the reasons for fluctuations in general include cyclical or sudden variations in supply and demand, expectations, macroeconomic conditions, weather and, increasingly, conditions in financial markets[13]. Price movements for many commodities also show a clear correlation with stock levels. As the ratio of stocks to utilization increases, prices fall[14]. Over the past few years, and particularly in the case of the latest crisis, it appears that supply-side rigidities caused by agricultural support policies and technological changes in the metals and minerals sector have also played an important role in exacerbating the magnitude of the price falls.

A. Current price situation

18. There is general agreement that, in real terms, prices of commodities are falling in the long term. For example, one of the longest series, *The Economist*'s industrial commodity-price index, fell in 1999 to its lowest level in real terms (adjusted by the United States GDP deflator) since the start of the series in 1845.

19. Developments over the past three decades show that this long-term trend has continued and

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[11] Annual press releases by Metals Economics Group, Halifax, Canada.

[12] From 1975 to 1998, developing countries' share of world production of aluminum increased from 9.7 per cent to 31.9 per cent, that of copper, from 23.8 per cent to 41.1 per cent, that of lead, from 15.4 per cent to 30.2 per cent, that of nickel, from 19.4 per cent to 24.7 per cent, and that of zinc, from 14.7 per cent to 38 per cent (World Bureau of Metal Statistics, *World Metals Statistics*, various issues).

[13] In addition, commodity prices would be expected to fluctuate more than manufactured prices because the markets for the latter are less competitive and prices are stickier in such markets. Moreover, instability would be higher under the flexible exchange rates which are increasingly adopted by developing commodity-exporting countries. (Liang, IMF WP, 98/163).

[14] This has significant implications for commodity policy that aims to reduce fluctuations, and calls for supply management measures which are often inherently difficult to pursue.

become more pronounced (statistical annex, Table 6). The decline since 1970 is slightly over 40 per cent when the combined commodity price index is deflated by the price index of manufactured exports of developed countries. The 1998 average prices were substantially lower than the 1979-1981 averages, not only in real terms, but also in current dollars, and this is the case for practically all product groups[15]. The price index, in current dollars, for non-fuel commodities remains at its lowest level since 1993 (when the lowest prices were experienced for many products after 1987)[16]. The temporary increases observed in January 1999 in the prices of a few commodities have been, as is very often the case, the result of "fortuitous"events on the supply side rather than of changes in market fundamentals.

B. Price situation in the light of increased productivity

20. Over the long term, price trends are influenced by fundamental changes in supply and demand conditions. Demand and supply growth have been briefly analysed in Chapter II. This section focuses on whether improvements in productivity and yields compensated for falling prices.

21. The utilization of improved seeds and chemical inputs, mechanization, and better farming practices have increased yields in agriculture substantially. Thus, the question as to arises whether producers have been able to make up for declining prices by increased yields. According to data from the Food and Agriculture Organization (FAO), between 1979-1981 and 1995-1997, yields per hectare increased by around 30 per cent for most products (an exception is coffee, for which there is no increasing trend). Although regional differences exist, they do not appear to be systematic. When price declines are taken into account, however (except for rice, tea and cotton, whose prices in 1979-1981 were particularly low), it emerges that prices declined much more than yields increased, and potential increases in earnings due to improved yields have been more than offset[17]. When prices are expressed in real terms by deflating them with export unit values of manufactured goods exported by industrialized countries, the losses are even greater (statistical annex, Table 7). Those producers whose yields increased less than the average are naturally faced with a much worse situation.

22. In the metals and minerals sector, cost reductions and productivity increases appear to take place in spurts and to be triggered mainly by crises, whether structural or cyclical. In such circumstances, high-cost labour intensive capacity is shut down[18]. Restructuring of this type took place during the 1980s and early 1990s, mainly in response to overcapacity. Labour productivity in metal mining in Canada increased at an annual rate of 12 per cent during the period 1986 to 1996, while that in nonferrous metal smelting increased at an even higher rate of 13 per cent per year. In the United States, labour productivity in nonferrous metal smelting increased at an annual rate of slightly over 6 per cent during the same period[19]. Given the technological homogeneity of the mining and metals industry and the weight of these two countries in world production, the figures are likely

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[15] For the special situation of vegetable oilseeds and oils whose price index is almost level with the base year, see the discussion on the Asian crisis, below.

[16] Prior to the recent surge following OPEC's action, and except a brief period in 1988, the price of petroleum had never been as low as they were in 1998 since 1976.

[17] Yields are only one element of profitability, as the costs of inputs that may have been the cause of increased yields, or wages, rise, the losses due to price declines augment.

[18] Tilton, John, *Labour Productivity, Costs, and Mine Survival During a Recession*, paper presented at the Eighth Annual Meeting of the Mineral Economics and Management Society, Ottawa, 15-17 April 1999.

[19] Natural Resources and Energy Canada, *From Mineral Resources to Manufactured Products: Toward a Value-Added Mineral and Metal Strategy for Canada*, 1998, p. 13.

to be broadly representative of productivity gains made in the industry as a whole, particularly since the early globalization of minerals and metals markets has exerted a strong equalizing pressure on costs across countries.

C. Falling international prices and consumers

23. The sharp and persistent declines in world prices have not been reflected in the prices paid by consumers. One of the reasons is the small part that is accounted for by commodities in the prices of final products. Moreover, the relationship of raw material prices with retail prices, for example between world market price for coffee price and retail coffee prices is, in general, asymmetrical; that is, retail prices for individual products often go up when international prices increase, but do not come down in the opposite case. A related development is the drastic increase in the difference between the international price of the unprocessed agricultural product and that of the final good. A recent study[20] found that in developed countries, the spread (or mark-up) between international prices (defined as cost, insurance and freight (cif), that is, import prices in developed countries) and domestic wholesale prices, as well as that between domestic wholesale and retail prices, widened since the early 1970s, and at an accelerated rate in the 1980s. Import taxes as well as domestic logistics costs have fallen, so the only factors that can explain this tendency are the relative weight and growth of other marketing and distribution costs in the value-adding process beyond the import price, or the market power of intermediary companies. (Comparisons of this kind for minerals and metals would be much more difficult, since the share of these materials in the final product is even smaller than agricultural products.) This tendency, and the asymmetry just mentioned, have worked against potential increases in consumption that could have been generated had retail prices declined with international prices.

D. Restructuring in the metals and minerals sector and price fluctuations

24. The restructuring process referred to above has resulted in a flat industry cost curve for most metals. Fixed costs are a high proportion of total costs, and exit barriers, in the form of high capital charges, high decommissioning costs due to environmental regulations and long-term contracts for inputs such as electric power, are important. As producers tend to go on producing as long as they can cover their relatively low variable costs, prices have to fall far before closures occur. In this industry with a homogeneous cost structure, this means that continuing production in spite of declining prices is a general phenomenon. Unwillingness to undertake production cuts while demand was still relatively strong although prices were falling contributed to the severity of the recent price falls.

25. Increased operational flexibility has also made it somewhat easier for mining and metals companies to respond quickly to increased demand. In most mines, production can be increased relatively quickly, particularly in large open pit mines which account for an increasing proportion of production. Metallurgical plants find it somewhat more difficult to raise production quickly, but as a legacy of the latest round of restructuring, most major metals companies have reserve high-cost capacity which has been "semi-retired" but which can be brought back into production in a matter of months in order to profit from a temporary price peak. For instance, over 10 per cent of the world's aluminium smelter capacity was closed more or less temporarily at the end of both 1997 and

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[20] Morisset, J., "Unfair trade? The increasing gap between world and domestic prices in commodity markets during the past 25 years", *The World Bank Economic Review*, Vol. 12, No. 3, 1998.

1998[21]. A large portion of this production capacity could be brought back into production relatively fast.

26. As a consequence of the reluctance to cut output when prices are low and the facility with which output is increased in response to price increases, the price troughs risk becoming longer and deeper, while the duration of the price peaks may become shorter. Moreover, investment in the mining and metals industry tends to be procyclical, that is, it increases when prices are high[22]. Since delays in projects are costly, the investment activity is usually continued even when prices fall. Consequently, the additional capacity usually comes into operation when prices have turned down, thus reinforcing the downward pressure on prices. In contrast, projects on which construction has not yet started tend to be postponed when prices fall.

IV. FINANCIAL CRISES AND COMMODITY MARKETS

A. Financial crises in major developing countries and impacts on the commodity sector

27. The impact of the Asian crisis, acting on both the demand and supply sides, has been a significant blow for exporters of commodities, aggravating the cyclical decline in prices which had begun in 1995[23]. Markets had been growing particularly fast in the region over the past two decades. The share of Asia (excluding China and West Asia) as importer of food products had risen from 7.1 per cent in 1980 to 10.8 per cent in 1995. The corresponding increase for agricultural raw materials was from 10.5 per cent to 16.5 per cent. The most striking rise was for ores and metals, where the share of world imports going to this region increased more than threefold, from 5.1 per cent to 16.1 per cent. Imports were severely curtailed as a result of the crisis as economic activity declined. The volume of imports into the most severely affected five countries (Indonesia, Malaysia, Philippines, Republic of Korea and Thailand) declined by more than 20 per cent in 1998. In value terms the contraction was one third. The corresponding declines volume and value terms in Japan were 5.5 and 17 per cent[24]. The relatively strong growth of demand in several developed countries, in particular the United States, however, made up for part of this shrinking demand, especially for metals.

28. For some such products, exports from the same five countries increased, partly as a result of declining local demand, but mostly in response to currency devaluations. This added to the downward pressure on prices but mitigated some of the negative effects of the crisis on the economies of these countries. Mainly as a result of problems with access to finance and importing necessary inputs, however, exports of industrial products stagnated. In 1998, for total exports (commodities and industrial products) among all regions, export volume growth was the slowest for Asia, increasing only marginally. The strong contraction of intra-Asian trade was only just offset by a sharp rise in extraregional flows. This sharp rise was accounted for mostly by the commodity sector. Consequently, although commodity exporters in general suffered from the impact of the Asian crisis on world markets, which aggravated the fall in prices already being experienced, the commodity sector provided a bright spot for the crisis-stricken countries of Asia.

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[21] U.S. Geological Survey, *Mineral Commodity Summaries*, Washington, D.C., 1999.

[22] Linnell, Richard, Untitled paper prepared for the UNCTAD Expert Meeting on the Impact of Changing Supply and Demand Market Structures on Commodity Prices and Exports of Major Interest to Developing Countries, Geneva, 7-9 July 1999, and Spilimbergo, A., *Copper and the Chilean Economy, 1960-98*, IMF Working Paper No. 99/57, 1999.

[23] For an early assessment which generally still holds true, see UNCTAD, *Trade and Development Report*, 1998, pp. 39-45. This section provides additional information on the performance of the commodity sector in crisis countries.

[24] WTO press release, PRESS/128, 16 April 1999, pp. 8-9.

29. Mainly as a result of devaluations in these countries, the export-oriented commodity sector, which is much less dependent on imported inputs than manufactures, emerged from the crisis relatively unscathed, and in many instances benefited from it in terms of profits in domestic currencies. In Indonesia, for example, "for 1998, the plantation sector -- grouping coffee, cocoa, rubber, oil palm, tea and other plantation crops -- managed to register growth of 6.5 per cent compared to the previous year. The overall economy, by comparison, contracted by almost 14 per cent", and a quadrupling of profits in 1998 was even reported for one of the largest plantations[25]. In Thailand, although the economy shrank by 8 per cent in 1998, things would have been much worse had it not been for agriculture. "During the first nine months of 1998, the value of Thailand's rice exports rose by 58 per cent [and] its exports of prawns rose by 35 per cent" in terms of domestic currency. Thus, agricultural exports offset some of the malaise in overall economic performance[26].

30. The negative impact of macroeconomic crises on commodity markets was demonstrated once again in January 1999 as Brazil encountered its financial crisis and devalued its currency. Commodity markets were affected immediately and significantly. For example, the prospect of rising exports from Brazil, coupled with bumper crops in several important producing countries and foreign exchange shortages in the Russian Federation, usually a big buyer, drove sugar prices below 5 cents per pound, the lowest level in more than 12 years. In the case of soya bean, Argentina cut its export price to stay competitive with Brazil, after the latter's devaluation[27]. The coffee market was affected as Brazilian shipments reached an estimated 5 to 6 million bags above its quota of 15 million bags under the Association of Coffee Producing Countries export programme[28]. Just as in the Asian countries, however, the relative strength of the agricultural sector in crisis situations is also illustrated in Brazil. In February 1999, while the Brazilian "economy as a whole moved deeper into recession, sales of farm machinery were 29 per cent higher than in the same month" of 1998[29].

B. Comparison with the 1980s

31. The impacts of financial crises in major developing countries on world commodity markets may follow different paths depending on the nature of the affected countries and on macroeconomic conditions in the rest of the world. In the 1980s, for example, commodity prices fell just as Latin American countries were in dire need of foreign exchange to pay their foreign debts. Moreover, these payments were particularly high and growing, as interest rates rose. Thus, the pressure to increase exports was very strong. The high interest rates also slowed economic activities and reduced the demand for imports in the main markets in industrialized countries, putting further downward pressure on prices. In the current situation, interest rates are relatively low and demand has been relatively strong in most of the industrialized world, particularly the United States. The urgency of increasing exports, and the downward pressure on prices, is therefore somewhat mitigated. Another difference between the economic conditions of the earlier crisis and the present one is that FDI and the presence in the crisis countries of transnational corporations (TNCs) with better access to finance are larger now than before. This helps in alleviating some of the financial troubles felt in the affected countries.

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[25] *Asian Wall Street Journal*, "Indonesian commodities traders fear election boost for Rupiah", 28 May 1999, p. 23.

[26] *The Economist*, "Winds of Fortune on South-East Asia's Farms", 3 April 1999.

[27] "Brazil crisis roiling Asian markets", SUNS, 27 February 1999, p. 5.

[28] F.O. Licht's International Coffee Report, Vol. 13, No. 24, 4 June 1999, p. 343. A new agreement on export quotas was reported on 8 July 1999.

[29] *The Economist*, "Growth in the prairies", 10 April 1999, p. 54.

32. As opposed to the crisis of the 1980s when the immediate reaction by the crisis countries was an attempt to increase exports, in the Asian crisis, the initial impact on commodity markets was a reduction in demand in these countries. The impact of increased exports emerged with a slight time lag and did not encompass many products. Brazil, however, is a significantly more important exporter than importer of non-oil commodities. Its commodity exports amount to more than half of the total for the five most seriously affected Asian countries, but it imports only about 10 per cent of their total. It is the world's largest exporter of coffee, sugar, soya and orange juice, and an important exporter of beef, pork and chicken. Compared to the Asian countries, Brazil may also be a more aggressive exporter, as its problems have emerged after several years of trade deficits, unlike the former, which had strong trade balances. Thus, if Brazil's economic difficulties continue, the major impact of its crisis on commodity markets is likely to come through exports, as in the 1980s.

C. Devaluations, commodity trade and transmission of crises

33. As the commodity sector is much less dependent on imported inputs than the manufacturing sector, devaluations carried out by affected countries have a stronger effect on the exports of this sector. The relative cost advantage obtained by commodity exporters in devaluing countries is larger than that obtained by exporters of most manufactured products. Export prices for commodities can be reduced while maintaining profitability in domestic currency more easily than for manufactured products. The commodity sector has, therefore, acted as one of the primary vectors in crises originating in developing countries. Commodity prices, in particular for products traded in bulk, which make up most of commodity trade, are set in competitive markets and respond quickly to changes in economic conditions, even to rumours, while prices of most other products, particularly industrial products, are adjusted gradually. Moreover, as developing countries produce similar products and are dependent on them, they feel a stronger impact than the developed countries which are much less dependent on commodities.

34. The impact of devaluations on the commodity sector differs depending on whether exportable products are consumed to a significant extent in producing countries or are primarily directed to exports. In the first case, potential increases in domestic prices resulting from devaluations lead Governments, conscious of the needs of domestic consumers, to take measures such as export bans or export taxes in order to maintain domestic consumption. In such cases, the increase of supplies on the world markets is curtailed and there may be little or no impact on the world market. In fact, markets may react with increasing prices to such situations, as has been the case, for example, with palm oil in late 1997, when Indonesia banned palm oil exports[30]. When the product is produced primarily for exports (and the devaluing country is a significant exporter), recourse to such measures is not necessary, and the impact of devaluation immediately manifests itself as reduced international prices as the devaluing country tries to increase its exports.

D. Links between financial and commodity markets

35. In recent turbulent periods in the world economy, ever larger amounts of speculative funds and increasingly closer links between financial and commodity markets have aggravated the instability of the latter.

36. The relationship between financial and commodity markets works in several ways. One of the

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[30] Rangkuti, H.T., Paper prepared for the UNCTAD Expert Meeting on The Impact of Changing Supply and Demand Market Structures on Commodity Prices and Exports of Major Interest to Developing Countries, Geneva, 7-9 July 1999.

more obvious is that the liquidity of commodity futures markets, combined with their large fluctuations, may at times make them attractive to investors who are drawn by the potentially large gains and not deterred by the correspondingly large risks of losses. Thus, the growth in speculative funds over the past decade or so has contributed to increasing instability of commodity prices, although it does not change market fundamentals. "In periods of heightened uncertainty about the future movements of commodity prices, or exchange rates, or inflation rates, very large amounts of funds can be switched, either for hedging or for speculation, from other asset markets into commodities, or vice versa"[31]. "The incursion of commodity funds as significant investors means that commodity prices increasingly anticipate, rather than reflect, changes in industrial production"[32] or in other aspects of the real economy that concern products with established futures markets.

37. Secondly, since profits of commodity companies tend to fluctuate in tandem with, but more than, commodity prices, investment in the shares of these companies, mainly mining and metals companies, will also attract investors who are looking for large potential gains. While investors would in theory be expected to base their valuations of shares on long-term profit expectations, their behaviour seems to indicate that increasing weight is accorded to short-term profit prospects. Shares in gold mining companies have traditionally been the preferred objective of such investment, but the shares of other mining companies have also been intensively traded at times of price fluctuations. It has been noted that the share prices of mining companies tend to anticipate price movements in metals. This has certainly been the case in the latest crisis, when metals price increases in the spring of 1999 were preceded by large increases in the shares of mining companies. For example, initially reasonable rises in copper and mining shares, anticipating certain closures (coupled by speculative rises in prices), had gone so far in late May 1999 that it was feared they would "render less likely the very closures on which they were predicated"[33]. Thus, an important effect of such rises in share prices is that, although temporary and speculative, they affect decisions concerning the real economy by reinforcing the cyclical behaviour of the companies concerned.

V. MARKET STRUCTURES AND THE COMMODITY ECONOMY

38. The world commodity chains, particularly for agricultural products, are undergoing significant changes in the manner in which they are organized, from production in exporting countries to the retail level in consuming markets.

39. This evolution can be reviewed at three levels, namely, the international markets, developing commodity-exporting countries, and importing countries. The common denominator of all three is a closer integration of international trade and production through the penetration of large transnationals and distribution companies, such as supermarket chains, into the agricultural supply structures of developing (and developed) countries. A few decades ago, the dominance of large companies in the world commodity economy was principally through their actions on international markets. Now, increasingly, it is also through their direct influence on what is produced, and how. While unprecedented opportunities may be opening up for some producers and exporters, benefiting from this trend and avoiding its negative impacts requires much greater business skills than before on the part of developing country Governments and entrepreneurs.

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[31] Maizels, A. "The Continuing Commodity Crisis of Developing Countries", *World Development*, Vol. 22, No. 11, 1994, p. 1692.

[32] *Financial Times*, "Analysts see recovery in base metals", 20 May 1999.

[33] Ibid.

A. The international level

40. At the international level, there is a continuing concentration of trade and vertical integration of large firms. Recent estimates indicate, for example, that in 1996, five TNCs accounted for close to one half of world trade in green coffee, up from about 37 per cent in 1980. In coffee roasting and manufacturing, concentration is somewhat higher, and it is four groups that account for one half of the market. For cocoa, in 1980 there were over 30 trading houses in London, and now this number has been reduced to around 10. After a series of mergers, for example, the six largest chocolate manufacturers account for 50 per cent of world sales. For vegetable oils, again a series of mergers and acquisitions in the 1990s led to the dominance of a small number of vertically integrated TNCs in the production, distribution and international trade of both oilseeds and oils. In grains as well, consolidation is under way, with the few big companies transforming themselves into integrated businesses encompassing trading, storage, processing and milling.

41. Another important change is the disappearance of traders. While earlier, traders acted as a bridge between buyers and sellers who were largely ignorant of each other and of prices, communications technology, including the Internet, has now closed this gap. Buyers and sellers can find each other much more easily and communicate instantaneously, increasing competition and cutting profit margins for traders. Traders' advantage was largely based on having information that others did not have, but that advantage is being eroded. "Price information is not only widely available but can be obtained instantly, severely reducing the opportunities for arbitrage and narrowing profit margins"[34].

42. Intensified competition favours those with access to cheaper finance and good logistics. Being big provides advantages on both accounts. With deregulation and the disappearance of marketing boards, large companies with warehousing and shipping facilities in the producing countries are able to exploit their financial and logistical advantages, even buying the produce directly from the farmer[35]. Similar developments are taking place for almost all food products. An example from the fishing sector illustrates the situation for many commodities. "The *trader* way of mind in the 60s and the 70s where traders' main objective was to buy cheap and sell expensive wherever they could is giving way to an *industrial* way of mind where buyers wish first of all to secure regular sources of supply of raw material. They are more interested in establishing long term relationships with suppliers"[36, 37].

43. The current setting is characterized by the need for greater capital resources sophisticated technology, including information technology, and human skills for competing in the more open but more sophisticated markets. Developed country firms are patently at an advantage in all these respects.

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[34] Pugsley, J., "Looking beyond commodities", *Trade & Forfeiting*, December 1998/January 1999.

[35] Improved logistics also allows large firms to buy increasingly on a "hand-to mouth" basis, thus reducing the cost of holding stocks and shifting the burden of such finance backwards. Chocolate companies, for example, which used to hold inventories covering a year or more, have reduced this coverage to as little as four months (Mosser, M., "Hot commodities", *Futures*, May 1999, v. 28 (5).

[36] Wiefels, R. C. "The Case of the Latin American Fishery Sector", paper prepared for the UNCTAD Expert Meeting on The Impact of Changing Supply and Demand Market Structures on Commodity Prices and Exports of Major Interest to Developing Countries, Geneva, 7-9 July 1999.

[37] The security of supplies of raw material is an important issue for all processors. For instance, several sugar plants in Viet Nam, some of them opened by foreign investment, were in trouble as cane supplies fell below the required levels ("Vietnam's sugar plans turn sour. Most foreign companies in the country are struggling to find cane", *Financial Times*, 4 May 1999, p. 28).

B. Commodity-exporting developing countries

1. Liberalization, production and trade

44. At the level of commodity-exporting developing countries, liberalization, in particular the dismantling of marketing boards, has had three main consequences. First, a large number of atomized traders emerged but many were later eliminated under intense competition, mainly due to lack of business skills, but also owing to difficulties with access to finance. Those that survive often have links with foreign firms. This helps them not only in market entry but also with securing finance. Second, the commodity sector was opened up to direct participation by foreign firms that deal with exporters, generally much smaller than themselves, and at times directly with producers. Third, the elimination of import barriers, as discussed above (*See Box 1: Subsidized exports and West African tomatoes)*, affected local production patterns. In the same vein, imported processed products, mostly with well-known brand names and often sold through foreign-owned supermarkets, have made important gains in developing countries at the expense of locally produced items.

45. The withdrawal of Governments from the commodity sector in developing countries has facilitated the changes mentioned above at the international level. Foreign firms, in particular large ones, were able to reach deep into the production, trading and processing levels in these countries. This had far-reaching consequences for the domestic private sector, which often has to operate in an unfavourable institutional, legal and regulatory framework. In the first years of liberalization, some of the marketing activities of the former government marketing boards were taken over by a range of local traders. Relatively quickly, however, these traders were replaced by international trading companies or their agents. Among the reasons for this are the relatively high cost of credit for the local traders, as well as their difficulties regarding logistics and risk management activities. Several examples can be cited from Africa. The "liberalization of the cocoa sector in West Africa has resulted in sharply increased concentration in the export sector, with a tendency for European grinders and trading houses to integrate backward into the origins, either directly or through agent relationships. ( ) Two factors drive this concentration. First, the trend towards bulk transportation of cocoa necessitates collection into large shipments. ( ) The second factor is access to finance"[58]. In Burundi as well, the number of exporters has sharply declined. Large local exporters who control most of the sales depend heavily on foreign finance coming indirectly from trading houses[59]. Again regarding financial constraints faced by indigenous commodity exporters, in the United Republic of Tanzania, the amount committed by two large Indian trading firms for financing cashew trade was greater than the aggregate borrowing, from local sources, of four cooperative unions and two parastatals[60]. Overall, this increased presence by foreign firms, facilitated by economic liberalization, has probably led to a fall in the percentage of the international market value of commodities retained in the country.

46. On the positive side, the most visible benefit from liberalization, in several countries, has been an increase of farmgate prices as a proportion of export price. Although an analysis covering the early

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[58] Christopher L. Gilbert, *Cocoa market liberalization, its effects on quality, futures trading and prices*. The Cocoa Association of London, September 1997.

[59] Ndayikengurukiye, C., "Incidences de l'evolution des structures des marches de l'offre et de la demande du cafe au Burundi", paper prepared for the UNCTAD Expert Meeting on the Impact of Changing Supply and Demand Market Structures on Commodity Prices and Exports of Major Interest to Developing Countries, Geneva, 7-9 July 1999.

[60] Mwase, N. "Economic liberalization and privatization of agricultural marketing and input supply in Tanzania: A case study of cashewnuts", African Economic Research Consortium, *AERC Research Paper* 86, Nairobi, November 1998.

years of liberalization indicated that "domestic terms of trade for agriculture moved much more favourably in the 'heavy intervention' countries than in 'light intervention' ones,"[41] there is ample anecdotal evidence for recent years illustrating an increase in farmers' earnings as a proportion of export prices.

Box 2

Liberalization in Uganda's coffee sector

In the coffee sector in Uganda, where a government exporting company competes freely with the private sector, the earnings of farmers as a percentage of export price rose from "20 per cent just before liberalization to a high of 78 per cent". One consequence has been a boost in production.

Liberalization has had further side effects on the commodity sector. In Uganda, as the agents of exporters collecting coffee in the countryside (who help in increasing the farmgate price through competition) are paid commission on the volume collected, less attention was paid to quality. It was only when the industry became more concentrated that quality began to improve. The liberty of farmers to sell to whomever they want has increased their earnings but made access to chemical inputs more difficult. Prior to liberalization, cooperative unions would provide farm inputs to the farmer to be paid at marketing. With liberalization, no single exporter advances chemicals to farmers because at marketing the coffee can be sold to anyone. Thus, more sophisticated financing schemes are called for to provide easier access for farmers to finance.

Based on Ngategize, P. K., "A case for Uganda coffee", paper prepared for the UNCTAD Expert Meeting on the Impact of Changing Supply and Demand Market Structures on Commodity Prices and Exports of Major Interest to Developing Countries, Geneva, 7-9 July 1999.

2. Economies of scale, market exigencies and increasing investment costs

47 There are two principal reasons why commodity producers and processors need increasingly larger amounts of finance to compete on world markets. First, modern technological advances provide considerable economies of scale in processing, but call for large investments in processing plants. For example, large crushing facilities are considered a necessity for competitiveness in the vegetable oils sector. Second, more stringent market exigencies call for ever larger investments to meet buyers' quality requirements and specifications[42]. For example, in the case of fish in Latin America, the cost of upgrading the installations and processing facilities to meet Hazard Analysis Critical Control Point (HACCP) requirements is estimated at $300,000 per firm, and this requires a total of $300 million for Latin America as a whole[43]. Modern flower plantations in Ecuador are reported to require "an average initial investment of $200,000 per hectare", in addition to other requirements for success, such as highly complex technology and marketing skills, and compliance with stringent market demands[44]. These conditions are, naturally, to the disadvantage of small producers who need to either organize themselves into larger cooperative entities or seek links with foreign firms that would extend the necessary finance and know-how.

48 Although developed country firms are usually the sources for such external finance, foreign investment in the commodity chain by large companies from developing countries is also observed. For example, a major Indian company, Tata Tea, is considering acquisitions of tea plantations in

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[41] UNCTAD, *Trade and Development Report*, 1998, p. 162.

[42] For stringent market requirements see UNCTAD, "Opportunities for vertical diversification in the food processing sector in developing countries" (TD/B/COM.1/EM.2/2), 23 June 1997.

[43] Investments were realized by the companies without benefiting from any official subsidy (as did, for instance, EU enterprises) (Wiefels, *op. cit.*, p.2).

[44] Thrupp, L. A., *Bittersweet Harvests for Global Supermarkets: Challenges in Latin America's Agricultural Export Boom*, World Resources Institute, August 1995, p. 39.

Kenya. Along with the advantage of securing year-round production possibilities for the company, this is hoped to help create an international brand image for Tata Tea[45]. Sometimes, developing country firms with access to sufficient finance enter the commodity chain at the lucrative downstream stages. A recent example is Bidvest of South Africa acquiring the food service subsidiary of United Kingdom food wholesaler, Booker[46]. Successful commodity firms which diversify into other commodity sectors in their own countries have also been instrumental in developing modern commodity production and marketing operations. In Brazil, for instance, the "poultry sector giants Sadia and Perdigão are investing in seafood distribution and aquaculture"[47].

49. Large investments by Governments are also necessary to meet market exigencies. Although such investments often take the form of institutional and technical support, direct investment may be necessary as well. In Argentina, for example, in order to be designated as "zero risk" for foot-and-mouth disease and to gain access to developed country markets, "a seven-year US$600 million campaign entailing the vaccination of the entire cattle herd was undertaken, partly financed by the Inter-American Development Bank". Only after having been declared free of the disease did the public and private sectors join forces to promote beef sales abroad[48].

C. Retail markets of importing countries

50. A large part of world commodity trade is in bulk products that go through considerable transformation before reaching consumers. For these commodities, changes in the retail markets of importing countries have little influence. For many dynamic food products, however, there seems to be general agreement that the single most influential factor in changing conditions of supply and demand has been the growth of the modern retailing sector, in particular, supermarkets[49]. For exporters of such "non-traditional" commodities as fresh fruit and vegetables, large retailers have provided important market access channels. Links with supermarkets provide producers with access to a growing market as well as incentives to improve quality and efficiency. Nevertheless, for many producers and exporters this is obtained at the expense of dependence on a single supermarket or importer in a given country for marketing, product innovation and technical assistance.

51. An important consequence of the growth and internationalization of supermarkets has been increasing global brand name recognition. As product attributes become more and more psychological, the importance of expenditures on advertising and related activities is increasing. This puts developing country traders at a disadvantage and contributes to the concentration in the commodity economy. Difficulties are almost insurmountable for developing country exporters to differentiate their products and establish new brand names to compete with the existing globally accepted ones. Success stories from developing countries in this respect are very rare. Opportunities may be easier in areas where the attributes remain more "generic", such as organic products, which currently enjoy rapidly growing demand.

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[45] *Businessline*, "Tata Tea scouts for estates in Africa", 11 May 1999.

[46] PricewaterhouseCoopers, *International Briefings*, June 1999.

[47] Weifels, *op. cit.*

[48] World Trade Organization, *Trade Policy Review Argentina*, (WT/TPR/S/47), pp. 109-110.

[49] OECD, "Vertical coordination in the Fruit and Vegetable Sector: Implications for Existing Market Institutions and Policy Instruments", Working Paper, No. 32, Paris 1997, p. 9.

Box 3

The impact of United Kingdom retailers on the fresh fruit and vegetables industry in Africa

Fresh fruit and vegetables (FFV) production is a growing industry in sub-Saharan Africa, especially Kenya and Zimbabwe. Between 1992 and 1996, FFV exports for Kenya and Zimbabwe grew by 50 per cent and 150 per cent respectively. More than 90 per cent of horticultural exports originating from Africa are sold through supermarkets, which control over 80 per cent of the United Kingdom market.

Diversification into FFV offers performance and risk-reduction benefits for producers and exporters with guaranteed market outlets. Given the large number of producers (e.g. over 2 million in Kenya) and linkages with post-harvest operations, the multiplier effects are substantial. Consumers relish competitive prices and a dedicated year-round supply of quality FFV and exotic fruits assured by stringent safety and due diligence requirements and adherence to quality, reliability and efficiency criteria imposed by large retailers and supermarkets. The greatest share of returns (over 45 per cent of price) is captured at the end of the chain by supermarkets.

The large retailers and supermarkets not only design and market brand names but also structure the supply chain, initiate proactive high-value research and development into innovation and value-adding activities, and provide financial services. These firms influence profit margins and help to determine who will participate in the chain. Although they monitor and evaluate the FFV chain, they do not have any direct supervision or control. The costs and risks of these activities are borne by the large producers, exporters and category managers in producing countries.

Links with United Kingdom supermarkets have provided African producers with access to a growing market as well as incentives to improve quality and efficiency. However, this may have been obtained at the expense of relying on United Kingdom supermarkets and importers for marketing, product innovation and technical assistance. Given that marketing skills and innovation are the essential ingredients of success, this reliance would leave the stakeholders in the producing countries highly vulnerable to substitution by competitors from other countries. Specialization in production targeted to particular buyers carries with it the following risks. The producer may learn to carry out only a narrow range of production and quality control activities; by having the non-production-related value-added activities in distant places, the scope for acquiring new competencies and sources of income is limited; concentration of innovation activities in the hands of retailers and importers leaves the producer end of the chain vulnerable to shifts in tastes of overseas consumers and in the marketing strategies of large buyers.

Another problem is concentration of exporters and growers, as the importers find dealing with large suppliers more convenient than with small ones. For example, in Kenya, over 70 per cent of FFV trade is dominated by just a few exporters. Noticeable also is the marked increase in the development of large owner-producer farms, some with direct supply links to supermarkets in the United Kingdom. To prevent further marginalization, good organizational arrangements are required for small-scale producers in the producing countries.

Based on Harris-Pascal, C., Humphrey, J., and Dolan, C., "Value chains and upgrading: the impact of UK retailers on the fresh fruit and vegetables industry in Africa", Institue for Development Studies, Brighton, United Kingdom, 1998.

VI. POLICY PROPOSALS

52. The preceding chapters give rise to the following policy proposals:

(a) The key market access problems faced by commodity exporters should be urgently addressed, with the elimination of tariff peaks and tariff escalation, placing agricultural commodities on the same footing as other products in the international trading system, and ending trade-distorting agricultural support measures by developed countries. Alternatively, developing countries should have the right, and be provided with the means, to offer equivalent levels of support to their own farmers and processing industries. In order to "level the playing field", international-level competition

policy issues should be dealt with, possibly by including them in World Trade Organization (WTO) negotiations. Financial and technical assistance for addressing supply-side constraints, particularly in the LDCs and covering marketing and quality improvements and support measures for developing countries dependent on the imports of essential commodities, should be included in negotiations on the liberalization of agriculture.

(b) The competitiveness of developing countries in international commodity markets needs to be enhanced. In this context, cooperative arrangements among enterprises in developing countries for improving supply reliability and quality could be useful. The establishment of a new generation of business-oriented marketing boards could be explored in order to fill some of the void created when the traditional marketing boards were abolished. Capacities of developing country enterprises to access and use information, particularly in electronic form, should be improved, and training to this end should be supported. Support should also be given to national efforts to develop a policy and institutional framework conducive to the use of modern financial instruments in commodity trade by farmers, traders, processors, financial institutions and investors. The establishment of natural-resource-based clusters consisting of mutually supportive commodity sector enterprises would help in production and export success as well as diversification. The capacity of local Governments to support commodity-based development programmes should be upgraded. Developing country enterprises should be assisted so that they can benefit from the trend towards product differentiation and establish their own brand marks. FDI in the commodities sector can contribute to improved international competitiveness of developing countries, as shown by developments in the minerals and metals industry. In order to maximize the contribution of foreign investment to development, it needs to be integrated into the domestic economic, social and political framework.

(c) The activities of producer/consumer commodity bodies are crucial for improving market transparency and exchange of information and experiences. It would be desirable to strengthen their effectiveness by both widening their scope of activities and ensuring the participation of all stakeholders. It would be also desirable to establish the means for international cooperation on commodities not covered by existing producer/consumer bodies. The activities of the Second Account of the Common Fund for Commodities should be expanded and increased funding made available to it to finance research and development and extension services in developing countries and adaptive research on production and processing aimed particularly at smallholders and small and medium-sized enterprises in developing countries.

53. In order to implement the above proposals, the following actions could be envisaged.

(a) The development of commodity-specific programmes of action on individual commodities to be undertaken by UNCTAD in collaboration with competent international organizations, and involving Governments, producers' and consumers' groups, the enterprise sector, independent experts and NGOs. This might also include the identification of new orientations for international commodity bodies, to increase their effectiveness.

(b) Development of options for filling the void created by the withdrawal of marketing boards in developing countries from many functions in the commodity sector, in particular regarding research and development, supply of basic technology and extension services, supply of inputs to farmers, quality control, warehousing, transport, financing, price risk management, and market intelligence. A principal objective will be to enhance the capacity of the indigenous private sector to take over the above functions.

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ANALYSIS OF EXPERIENCES IN SELECTED SERVICES SECTORS

Note by the UNCTAD secretariat

Executive summary

The ability of developing countries to increase their participation in world trade in services is essential to their deriving benefits from globalization. Service exports provide developing countries with an opportunity to channel acquired skills into high-value export earnings. For poorer developing countries, exports of services can be particularly crucial in diversifying away from dependence on one or two primary commodities. However, the service most relied upon in such strategies, tourism, can bring additional vulnerabilities, and accordingly, a coherent service development strategy should aim at a continuous upgrading into more technologically advanced and specialized services. This requires giving the highest priority to development of competitive services sectors, particularly infrastructural services. Attracting investment to the services sectors and acquiring technologies so as to strengthen the positions of services producers in developing countries are both a key to success. Strategies must address fiscal and other institutional disincentives to services exports. Inevitably, developing country firms find themselves handicapped by lack of financing and technology, but the judicious channelling of skills and effective use of labour cost advantages can lead to an ability to penetrate world markets. Developing countries have difficulties in identifying barriers to their potential service exports. Most of the information provided to developed countries on barriers originates with TNCs that deal with the regulations of a large number of countries. Efforts should be made to assist developing countries to identify these barriers. Developing countries' potential to export services, particularly labour-intensive services through information networks, has been facilitated by the growth of the Internet, however, there are formidable technological and financial problems to be overcome, and a whole new "generation" of regulatory and competition issues to deal with, some of which may have to be addressed in GATS.

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I. EXPANSION OF TRADE IN SPECIFIC SERVICES SECTORS

A. Introduction

1. At its third session, the Commission decided to include on its agenda the "analysis of certain service sectors, including analysis of successful experiences in those sectors, particularly those which enhance the export capacity of developing countries (such as professional and business services and access to transport services), including the development implications of electronic commerce".

2. This background note has been prepared as a contribution to discussion on this item. Chapter I examines successful experiences in service strategies, both in strengthening the domestic services sector and in increasing exports of services. Chapter II identifies barriers faced by developing countries in expanding their participation in the world market for services, which can frustrate these strategies. Chapter III examines how the growth of electronic commerce has provided new challenges and opportunities for developing countries in designing such strategies and penetrating world markets for trade in services, along with the new negotiating issues that it entails.

B. Identification of comparative advantage and competitive strategies

3. Globalization, privatization and improved information technologies are expanding the global markets for services and providing increased business opportunities for suppliers from developing countries. However, these opportunities will be realized only if the following key elements are present: (i) if Governments give the highest priority to services sectors with export potential, improve the service infrastructure and undertake human and institutional capacity-building and regulatory reform; (ii) if private sector firms have sufficient capacity to produce the critical mass of services necessary for exports; (iii) if the services are cost-competitive; (iv) if the services produced are of an acceptable international quality level; (v) if the service firms are given sufficient support and incentives to develop market linkages; and (vi) if firms have access to target markets. As Article IV of the General Agreement on Trade in Services (GATS) clearly recognizes, access to technology is essential to building export supply capacities in services sectors in developing countries, which must cope with the problems presented by capital scarcity and overall supply-side constraints. These factors have presented formidable problems to many developing countries, but some developing countries have nonetheless achieved considerable success in exporting technical services where availability of highly trained professionals was the key to their success. Availability of infrastructure services, including financial, transport and high technology-based communication services, may lead to export capacity-building in other sectors, including through the attraction of private investment.

4. In many countries the first problem to be addressed in drawing up services strategies was to correct regulatory and fiscal disincentives that penalized the export of services in relation to goods. As services had traditionally not been viewed as an export sector, mechanisms used to promote exports of goods were not available to service producers. Service producers suffer from high levels of tariff protection on imports of the capital goods and other inputs required to produce the service efficiently. Service exporters often lack access to export credits and are unable to obtain the rebate of indirect taxes on exports permitted to goods exporters. By contrast, some

countries such as Colombia have introduced policies to enable service exporters, in sectors such as tourism, medical services and land transport, to benefit from duty drawback on imported goods used to produce the exportable services.

5. The development of an export capacity in the services sector has been central to some developing countries' efforts to diversify exports so as to escape from excessive dependence on the exports of primary commodities. The example of Mauritius is noteworthy. The initial strategy of the 1980s involved the development of the tourism sector, with the resources for investment coming from windfall profits arising from high world sugar prices at that time. However, Mauritius has maintained its policy of diversification into the services sector, with the development of a free port area as a hub-port for servicing southern and eastern Africa. Regional development and economic cooperation arrangements were entered into as an institutional precondition for expanding services into these countries. Capital was raised through government equity investment and loans, including assistance from multilateral financial institutions. International competitive bidding was invited and as a result, consultancy services were supplied by the foreign firm (imported) for the development and implementation of the project, since know-how was not available locally. The port services are rendering sizeable revenues at present.

C. Country examples

1. Offshore activities

6. Mauritius' policy of diversification led to the development of offshore activities. A regulatory, legislative and fiscal environment was established fully to support the development of the offshore sector, particularly in the areas of investment funds, investment holding and international trading. Provisions were made for investor protection, thus ensuring that the necessary safeguards are in place to maintain the country's reputation as a credible and safe jurisdiction. Legislation has been regularly revised to keep pace with developments in other offshore jurisdictions and to provide more efficient investment vehicles to investors. The Mauritius Offshore Business Activities Authority (MOBAA) was established as a regulatory, licensing and supervisory body for all non-banking offshore business activities. Offshore banks remained under the supervision of the Central Bank but were exempt from reserve and prudential requirements, although subject to 15 per cent profit tax. The total number of approved offshore entities reached 8,150 in 1998, with gross revenue of $ 77 million in 1997. The total direct and indirect benefits of the offshore sector has been estimated at 2.5 per cent of GDP. Total employment in the offshore sector was small (0.15 per cent of the workforce), but characterized by high value-added and earnings potential.

7. A double taxation agreement with India, which coincided with the liberalization of the Indian economy and launching of the offshore business in Mauritius, provided an extraordinary opportunity for channelling investment into India and contributed to the success of the offshore business in Mauritius. Mauritius, being a tax-planning jurisdiction, has focused the development of its offshore centre on the use of its growing network of double taxation agreements, which has reinforced the seriousness with which the country is viewed as a tax-efficient offshore jurisdiction for structuring investment abroad. The various tax treaty benefits have appealed to investors aiming to minimize their costs when repatriating income from their investment in the treaty country in which they invested. An estimated $ 6 billion worth of funds has been invested in India through Mauritius, thus representing 32 per cent of India's total foreign direct investment (FDI) inflows and foreign portfolio investments.

8. Mauritius' policy is to focus the second phase of development of the offshore sector on using acquired experience to expand services into Africa and Asia and also to build capacities in other services sectors. Among the new business activities, MOBAA is encouraging the development of the captive insurance business and of an aircraft registry and financing centre for mortgaging and leasing of aircraft and its spare parts. A crucial factor in the success of these policies has been the fact that Mauritius has sustained an excellent international "image", particularly through export of tourism services. The country's geographical location, its membership in regional blocs and its achievements as a reputable offshore jurisdiction have also been important ingredients for success.

2. Port services

9. Sri Lanka has successfully exploited its natural advantage in developing port services as a leading hub-port for container traffic in the South Asian region. Its specialization as a purpose-built container terminal was supported by internal capacity-building, leading to productivity gains and growing export earnings. Over the period 1979-1997, container throughput grew nearly hundredfold, the country's global ranking reached 31 in 1993, and demand surpassed the capacity of container handling at the Port of Colombo. To reinforce its position vis-à-vis competition in response to market demand, further expansion and modernization of ports has been envisaged, and the financing of this expansion has been provided by direct budgetary inputs, supplemented by private investment by the awarding, through open international bidding, of "build-operate-transfer" and "build-operate-own" contracts. Ancillary port services, including ship repair, were also opened up for privatization. On the institutional side, to promote fair competition among private and public service providers, an independent Port Regulatory Authority was established. Upgrading of human resources was seen as an important part of improving efficiency and productivity of the port operations, and international cooperation was sought to train key persons in use of modern technology and information and computer systems. As a result, the transportation sector has been playing an increasingly important role in Sri Lanka, with net surplus generated by the airline, shipping and port services increasing at an annual rate of 13 per cent in recent years.

3. Engineering consultancy services

10. India has created capacity in specialized engineering consultancy services, which has become an important export sector, the total export earnings of two professional associations in 1997-1998 reached $ 330 million. Exports of engineering consultancy services were first channelled to Africa and Asia, later to the Middle East, and more recently to other markets. In response to growing environmental concerns, most Indian engineering service enterprises became involved in some form of environmental and energy consultancy. Although domestic sales are at the centre of their business interests, a number of firms have adopted export-oriented strategies. As a result, 17 per cent of all engineering consultancy firms received more than half of their income from sales abroad. An important element of their success was the availability of representation offices and established networks abroad, including through joint ventures. However, Indian firms have had only limited success in international competitive bidding, since often they fail to comply with other-than-technical elements of the bidding procedure, e.g. in providing bank guarantees. India's moderate success in the export of consultancy services illustrates the difficulties faced by developing countries in exporting their knowledge-based services as a result of a credibility gap regarding the level of competence and sophistication achieved by them in science and technology and other knowledge-based fields. To offset this bias, a positive information campaign through professional journals and electronic information networks needs to be undertaken to disseminate

their successes and credentials, and multilateral financing institutions need to be encouraged to include competent consultancy firms from developing countries in ther database of consultants. On the other hand, India's proven comparative advantage in engineering consultancy services has encouraged the Government to open its markets to competition, by removing controls on foreign capital participation and extending full national treatment to foreign firms supplying their services in India to foster further innovation.

4. Telecommunications network services

11. In Chile at the beginning of 1980s, the telecommunication industry was characterized by a lack of available phone lines and of the necessary investment funds for the development of the required infrastructure. The sector was opened up for domestic and international private investment as the only viable solution for attracting the necessary funding and, by the early 1990s, the State had withdrawn fully from ownership of the national telecommunications companies. It retained a subsidiary role for assisting in the development of telecommunications in the areas that were less profitable but desirable on social grounds, and in promoting more balanced regional development within the country. State-of-the-art technology has been introduced in Chile, including network digitalization, fibre optics and satellite equipment. With the market expanding at an average rate of 20 per cent annually, the number of telecom companies was expected to reach the highest per capita in the world, and the sector has become the second largest recipient of FDI in services in Chile. The supply of fixed-line and mobile phones, marked by lower tariffs and overall telephone charges, reflected global trends and matched the growing needs of the population. The availability of an efficient telecom infrastructure contributed to attracting FDI to the economy at large and enabled Chile to enter into agreements with Peru and Argentina to supply telephone services to the border region, thus building its first export capacities regionally. It also provided a good basis for the participation of Chilean service providers in international electronic trade in services.

D. Sectoral Examples

1. Maritime transport

12. The success or failure of developing countries trading low-value goods with little potential for differentiation but considerable risk of substitution is largely determined by transport availability and cost. In 1996, the share of freight cost in import value of developing countries was 8.1 per cent. These high costs compare to an average 4.2 per cent of import value in the case of developed market economy countries. Potential transport problems are exacerbated by trade imbalances, which have an impact on the cost and availability of transport services, this can be a particular problem for countries trading low-value commodities. An example is provided by Asian trade routes, where some ocean carriers registered trade imbalances of up to 3:1 between outgoing and incoming liner cargo volumes.

13. Companies in a number of developing countries have taken over a lead role in world shipping. These countries include Taiwan Province of China, Republic of Korea, China, Singapore, Malaysia and Kuwait. Others such as Mexico, Colombia and Chile are playing a regional role. In addition, of the leading 20 container service operators, as measured by the number of vessels and total shipboard capacity, eight are operators originating in developing countries. The emergence of some of these major maritime powers has been made possible by massive government intervention. Alternatives include the formation of regional joint ventures for the operation of specific types of services on selected trade routes, concentration on intra-regional trade or the

provision of feeder services in cooperation with global mainline carriers. Liberalization of market access and globalization of production of shipping services have in principle resulted in a situation where profits are no longer reserved or market niches protected against foreign competition. However, since competitive pressures have not been limited to mainline operations but are building up everywhere, finding a market niche would not be a substitute for developing countries' carriers but only complementary to improving efficiency.

14. Developing countries have been the main suppliers of labour for the world merchant fleet. The Philippines, the world's largest single supplier of shipboard labour, accounts for some 20 per cent, or 200,000, of total seagoing staff. An estimated 50 per cent of crews on vessels flying flags of OECD member countries are nationals of non-OECD countries.

2. Construction and engineering design services

15. The international construction services market has seen the arrival of a growing number of new players from developing countries. Following the oil price explosion of 1975, the Middle East became the largest regional construction market, where financing posed no problems for international construction service firms. A few such firms, from a handful of developing countries, took advantage of the opportunities offered by this lucrative market and targeted infrastructure projects to which they assigned engineering personnel and construction workers from their home countries as well as low-cost labour from other developing countries. Their share of the international market approached 20 per cent in the early 1980s, but with the slowdown in the Middle East market, their market share dropped well below 10 percent in the 1990s. Nevertheless, a few such firms from China, Republic of Korea, Brazil, Singapore, Indonesia, Argentina, Mexico and the Philippines continued to appear among the top 250 international contractors.

16. An increasing number of developing countries have made substantial progress in producing professionals with specific skills such as engineers, architects , designers, economists, financial analysts and ecologists. Furthermore, many of these countries have succeeded in developing a managerial and organizational ability which, together with the low costs in these countries of skilled and unskilled construction labour, has helped construction firms to penetrate international markets. On the other hand, inter-firm cooperation across national borders involving construction firms from developing countries has increased and contributed to capacity-building and competitiveness. It has mainly been of an ad hoc nature and concerned with production and trade. More specifically, subcontracting has proven to be an entry point in the international market for small and medium-sized enterprises (SMEs) in this sector.

17. The global outsourcing of inputs by developed country construction firms, including the search for lower- cost engineering design, equipment and construction material on the one hand, and the interest of developing countries to acquire foreign technology on the other, are among the factors that explain the surge in North-South collaboration agreements. This has helped the international outsourcing of technology and improved marketing and managerial practices of developing country partners, thereby strengthening their export performance. Despite these positive factors, however, developing country construction firms continue to face challenges to the expansion of their exports. One important factor is the growing importance of financing in winning projects in export markets and the weakness of developing countries in tapping international financial markets. Other equally important factors are the continued obstacles to labour mobility among countries and the limited access of developing country firms to developed country markets.

due among other things to government procurement policies and procedures in these markets and various other types of non- tariff barriers which are not transparent

18. Complex environment and safety regulations, standardization, registration procedures, personnel qualifications and licensing requirements act as deterrents to doing business in a foreign market and tend to discriminate against foreign companies. The problem is compounded in the case of some countries where these procedures vary from one state or region to another. In dealing with procurement and "buy national" preferences, consideration may be given to ways and means of achieving a more liberal and transparent government procurement policy. Wider diffusion of information technology in the construction and engineering design services industry is particularly important.

19. The weakness of developing countries in the engineering design segment is notable. In effect, over 95 per cent of the international engineering design market is controlled by developed country firms. This stems from the characteristics of the services which are knowledge-intensive, and the particularly important use of information technology (IT), in their production and delivery, mainly in developed countries. This technology has allowed time- and labour- saving and quick adjustments to changing market conditions. As a result, sizeable savings in drafting costs have occurred together with improved design speed and accuracy. This technology has added to the challenges that engineering design firms in developing countries face in today's globalized and liberalized environment. Investing in information technology is a costly and risky undertaking due in part to its capital requirements, the proliferation of IT standards and the rapid obsolescence of IT systems. Despite their weakness in this subsector, it is encouraging to note that a handful of engineering design firms from developing countries have nevertheless succeeded in entering the international design market.

E. Efforts at the regional level

20. Although, as noted above, some developing countries have been able to implement successful service export strategies aimed at the world market, for many developing countries the export markets for most services are neighbouring countries. Thus, regional and subregional integration would seem to provide excellent opportunities for expanding trade in services and for developing country firms to strengthen their capacities to export to the world market. However, developing countries have been slow to incorporate services into regional and subregional integration agreements. In fact, in most cases the GATS commitments were the first exchange of obligations among the participants in such schemes.

21. Negotiations on the liberalization of trade in services are taking place in different forums and at different levels -- bilateral, regional and multilateral. All negotiations are, however, interrelated, since commitments adopted at one level influence developments in others, making the whole negotiating process rather complex. The higher the level of commitments adopted in the multilateral framework and the wider their scope, the smaller is the space left for preferential liberalization to take place in the framework of bilateral or regional agreements. Members of subregional integration agreements therefore need to determine a common position as to the sectors in which access to foreign services could have the greatest positive impact on their respective economies and development goals. The first priority in a subregional grouping would be to strengthen and harmonize the regulatory structures governing a priority list of services. As noted from the above examples, access to the regional market and the existence of a regional or subregional institutional structure can provide the framework within which investment can be

attached to as an export-oriented services sector. New export capacities can be enhanced by preferential access to neighbouring developing countries, and that access can in turn be enhanced by cultural and linguistic factors.

22. Support for the natural tendency to export to countries in the same region may be provided, for instance, by removing visa requirements and limitations on the movement of natural persons, by establishing common curricula among the members of the regional grouping, which would greatly facilitate the mutual recognition of diplomas and other professional qualifications, by easing the requirements for obtaining the necessary permits and authorizations for foreign firms to conduct various aspects of their operations in the host country, and by opening up public procurement to firms from other countries of the region.

23. Strategies to integrate cities into the global economy by establishing an appropriate mix of services have been followed in many countries. Services are increasingly concentrated in a relatively few "global" or regional cities, whose business consists mainly of the production of specialized information services, such as financial services, media services, educational and health services and tourism, including business tourism. A city grows in importance if it performs a number of functions effectively and efficiently, which can be oriented around serving a subregion. Connections with international transportation and communications networks are crucial.

II. BARRIERS TO EXPORTS

24. The efforts of developing countries to develop services as a major export item and contributor to development and to penetrate the world market for services have faced considerable barriers. These include barriers to market access and national treatment, as defined in Article XVI and XVII of GATS, as well as difficulties in market entry caused by anti-competitive practices, subsidies and so forth. The next set of negotiations on trade in services under GATS Article XIX, aimed at the further progressive liberalization of trade in services, is scheduled to begin before the end of 1999 and can provide an opportunity for developing countries to address these barriers.

25. Matrices drawn up to illustrate the extent of GATS members' commitments generally indicate that developed countries have accepted commitments in many more sectors than developing countries. However, such comparisons conceal the facts that (a) many of the commitments offered by developed countries simply bind the status quo treatment without providing meaningful market access, (b) significant commitments have not been made in the mode of greatest importance to developing countries, i.e. movement of natural persons, (c) developing countries do not have the capacity to benefit from the access provided in developing country markets in most cases, and (d) anti-competitive situations, market dominance, restrictive business practices (RBPs), subsidies and the like prevent developing country firms from effectively competing in foreign markets. In addition, special geographical or cultural factors (e.g. non-acceptance by consensus of foreign audiovisual material in a seemingly "open" market) can also effectively close markets.

26. The GATS architecture permits developing countries to offer trade liberalization commitments in those service sectors where access to foreign services and foreign investment is considered to be most capable of having a positive impact on the economy. For example, most developing countries have made commitments with respect to commercial presence in the tourism sector so as to encourage foreign investment in tourist facilities. The GATS also permits the use of performance requirements to ensure that the beneficial effects of such foreign presence are

maximized. In certain sectors, such as environmental services, the main interest for developing countries at present is to have access to foreign services, since this is the precondition for them to be better equipped to deal with environmental problems and, eventually, to become providers in this sector. Thus, participation in the GATS negotiations should be seen as an extension of the national services strategy. Commitments could be made to encourage foreign investment, enhance efficiency and meet other sustainable development goals, with requests targeted at those foreign measures and practices which impede access by developing country suppliers to world markets or reduce the benefits to their firms of participation in trade in services.

A. Movement of natural persons

27. The movement of natural persons is key for developing countries' participation in the world market for services. Their perceived labour cost advantage has led developing countries to give priority to commitments relating to Mode 4 of GATS, the movement of natural persons. Commitments in this mode are largely linked to commercial presence, which in effect provides flexibility to transnational corporations (TNCs) in moving executives and technicians around within their global corporate networks. Both developing country firms without such commercial presence and independent professionals from those countries suffer, by contrast, from visa restrictions and economic needs tests (ENTs). This is evident for service activities involving low skills (e.g. construction and domestic help) as well as high skills, customized software, and participation in various international projects involving a multiplicity of skills and areas of expertise. Furthermore, there is a lack of sectoral specificity in the GATS commitments on movement of persons, which underscores the importance of obtaining commitments on Mode 4 in these sectors.

28. ENTs are extremely prevalent in qualifying commitments with respect to the movement of persons and, due to their discretionary and non-transparent nature, pose major barriers to trade in services and nullify the opportunities for market access otherwise extended in the commitments. The tests imply that the relevant government agency would grant market access if certain conditions were met which reflect the demand for services or the ability of nationals to supply such services. These conditions may be quantitative or qualitative, taking into account the local market conditions and availability of the local services suppliers, characteristics of the population, or any other criteria. This suggests that a further opening of market access for natural persons would depend on the extent to which the application of the ENT could be restricted or made more predictable. The growing dynamism of the markets implies that a shorter time-span is allowed for problem-solving, which in turn calls for the immediate availability of professional services. All delays related to visa applications and other similar formalities negatively affect the delivery of professional services by foreigners.

29. The lack of recognition of diplomas and professional qualifications greatly hampers the movement of natural persons, which means that the establishment of harmonized curricula or mutual recognition of qualifications is a precondition for the successful movement of natural persons and for establishment abroad. Professional associations may also set up rules which limit foreign professionals' ability to deliver services abroad. Mutual recognition agreements among countries of diplomas or professional experience have become more popular in recent years. Several countries have notified mutual recognition agreements under GATS Article VII.4. In the Asia-Pacific Economic Cooperation (APEC) nations, work has started on the preparation of a directory on the requirements for provision of professional services, including accountancy, engineering and architecture. A large number of bilateral agreements on recognition of practice standards have also been concluded in the region. In June 1999, a text for a United States-

European Union (EU) framework agreement for negotiating mutual recognition was finalized, although it still has to be approved by the Governments. The agreement would set conditions for all services sectors for the licensing, accreditation and certification of service providers.

30. The issue of "brain drain" is relevant in the context of ensuring that the movement of natural persons is beneficial to the exporting countries. Remittances sent home by such persons, and the exposure to a new and often more stimulating and technologically advanced working environment, represent the positive sides of the phenomenon, however, the exodus of qualified personnel from needy countries to wealthier ones is a serious problem. Moreover, in most countries, the education of qualified personnel is subsidized by public funding and requires significant investment. The outflow of professionals in effect provides a subsidy to the receiving country for which there is no compensation. Measures to ensure that professionals come back to their countries of origin after a temporary stay abroad would be important in this context.

B. Movement of consumers

31. Tourism, health and education are examples of services sectors where consumption abroad is particularly relevant. Movement of consumers in the tourism sector is in some instances limited by the difficulties associated with the delivery of visas, hard currency regulations, and insufficient availability or inadequacy of air transport services to and from tourist-receiving countries. The "image" of the country is crucial for success in tourism; one of the main barriers to tourism exports by many developing countries is the negative image they receive in the media. Travel warnings issued unilaterally by Governments of the main tourist-generating countries emphasize the risks and sometimes remain in place after the cause which justified the warnings has been removed. Another related problem for some developing countries is the unilateral certification of airports in tourist-receiving countries, which may jeopardize tourist flows to these countries and consequently also the viability of the countries' airlines.

32. In the health services sector, the non-portability of health insurance is the major difficulty hampering developing country delivery of health services to foreign patients. This situation is reflected in the commitments scheduled by Bulgaria, Poland and the United States, which explicitly indicate restrictions on the coverage of public insurance schemes outside the country. The same situation occurs, however, in those countries which allow consumption abroad without limitations. The EU has dealt with the problem of non-portability of public health care insurance by a system under which sickness benefits in kind are provided according to the legislation of the country in which a EU citizen resides or stays as if he or she were insured in that country. After delivering the service, a bill is submitted to the health insurance of the home country for payment. In some other countries (e.g. Costa Rica, Egypt, Jordan), patients can be authorized to obtain treatment abroad at the cost of the national health system (NHS) when the NHS is not in a position to provide the required treatment. Some countries have signed bilateral agreements which allow a total or partial portability of the public health insurance. A multilateral solution to this problem could be of considerable utility.

33. As far as education services are concerned, the movement of students for undergraduate and postgraduate education takes place between countries at all levels of development: from developing to industrial countries, between industrial countries, and also between developing countries. Limitations on the consumption abroad of education services are very rare in all subsectors. However, any horizontal measure that restricts the mobility of students, such as immigration requirements or foreign currency controls, represents a barrier to consumption abroad.

Another indirect barrier includes degree equivalence, i e the difficulty students may have in translating the degrees obtained abroad into national equivalents. The recognition of diplomas, or the establishment of internationally agreed curricula, is an issue which may deserve the attention of developed and developing countries alike.

C. Commercial presence

34. The liberalization of trade in services, notably through GATS Mode 3 commercial presence, can make a major contribution to the achievement of developmental and social goals. However, certain prerequisites must usually be met for liberalization to have a positive impact. For example, it has been clearly shown that the liberalization of the financial services sector should be preceded by the implementation of sound prudential legislation. In the health sector, the presence of foreign suppliers can strengthen or weaken the health care system depending on the structure of the domestic sector. In the environmental services sector, foreign suppliers can make positive contributions to the protection of the environment if technically adequate, enforceable legislation is in place and if funds are available to the developing country concerned to pay for such imported services. Tourism development may not have a positive impact if not integrated into the local economy. Special social and ethnic conditions may call for a unique strategy, such as the Malaysian position on financial services. Maintaining cultural integrity is viewed by many countries as requiring a particularly careful approach to the liberalization of audiovisual services.

D. Sector-wide issues

35. Ensuring a positive impact of liberalization requires that liberalization commitments be devised in clear recognition of the specificities of the national service sector concerned and of the relationships between sectors. The expected benefits of trade liberalization in the services sector may be frustrated by the inadequacy of domestic policies and by the lack of a well-articulated domestic regulatory framework. An appropriate legal framework is required to prevent abuses in deregulated markets and protect domestic consumers, while ensuring transfer of technology and the development of domestic competitive supply capacities.

36. An adequate regulatory structure has to be in place, for example for prudential purposes, to ensure respect for technical standards or professional qualifications. The process under Article VI of GATS would be of considerable importance to ensure that the benefits of liberalization commitments on the national economy were maximized. Decisions as to where to make such commitments would need to take into account possible social or environmental "dividends" resulting from liberalization.

37. UNCTAD's analysis of specific services sectors has shown that there are areas where a regulatory framework is particularly important. In the air transport sector, domestic disciplines in the area of competition policy have been necessary to avoid unfair pricing practices and to counter the effects on trade of mergers, cartels and the abuse of dominant positions by individual airlines or consortia. This is particularly important in the case of developing countries that do not have a national airline. Alliances among airlines are common, and have obtained sectoral exemptions to anti-competitive conduct, contained in anti-trust legislation, with effects in international markets. Clearly, exemptions of this type need to be carefully examined in the context of the application of competition policy to the industry. Regulators are facing problems in dealing with alliances, since they have to regulate from a national standpoint a phenomenon which has effect across national borders.

38 Regulations that would secure a competitive environment in each developing country are vital preconditions for liberalization of market access to proceed successfully. The availability of the emergency safeguard mechanism as a temporary fall-back option could also support the efforts of developing countries to further open their air transport services market for competition. In the case of the tourism sector, anti-competitive conduct -- such as exclusive dealing clauses incorporated into contracts between tour operators and hotels in developing countries, or clauses on import and supply requirements in franchising contracts -- appears to have the potential for a major impact on the ability of developing countries to benefit from trade in tourism services.

39 Appropriate legislation also needs to be in place to minimize the risk that FDI occurs only in the most profitable segments of the market. Some developing countries are already putting adequate instruments in place to counter this practice. Brazil, for example, allows foreign insurance companies to operate in the areas of life insurance and pension funds only if they are also active in the health sector. In other cases, the development and enforcement of a regulatory framework is necessary to generate the demand for specific services. Domestic environmental legislation, market-based incentives and fiscal policies are the main demand-generating factors in the environmental services market, for instance.

40 Paradoxically, in certain circumstances the liberalization of trade in services can create the risk of reduced access to essential services and vulnerability. For example, some developing countries which liberalized their air transport sectors as part of policy to promote tourism found themselves at the mercy of one or two foreign airlines. The review of the GATS Air Transport Annex will focus international attention on the need to design a system that enables developing countries to "compete effectively" in the world market for air transport.

41 Vulnerability can be created by the liberalization of audiovisual services if this leads to the promotion of images and tastes which further consumption of foreign goods and services and an undermining of development efforts. It has been emphasized in early theoretical literature that since most services are produced and consumed simultaneously and thus there are few means to test a service without consuming it, the "image" of the services provider is essential to competitiveness. Thus, audiovisual services have an importance going beyond their cultural aspect to include also a strategic role in the development process.

42 Appropriate domestic policies in developing countries in the field of tourism can reduce the risk of "leakage", i.e. the low retention within the country of the revenue generated by total sales to foreign tourists. Leakage, which partly negates the economic and development benefits accrued from tourism in developing countries, can be due to factors such as the import of materials and equipment for construction and consumable goods, such as food and drinks, to cater for the needs of international tourists, the repatriation of income and profits earned by foreigners, overseas promotional expenditure, among others.

43 Transparency in public procurement practices may have a particularly strong impact on certain services sectors. The lack of transparency in public procurement practices may entail unnecessary costs and delays and discourage foreign firms from offering their services. In the case of environmental services, where most developing countries still rely on foreign services, the opacity of developing country markets may limit the availability of these services.

III. ELECTRONIC COMMERCE AND SERVICES

44 Although the possibilities of exporting services through information networks has been recognized since the 1980s, most developing countries initiated their service strategies and entered into commitments in the WTO without foreseeing the dramatic expansion of the possibilities of electronic commerce. Developing countries in different geographical regions are presently delivering on-line blueprints, designs, engineering data, drawings and maps, professional and business services, health and education, travel and ticketing services, advertising computer-related services, entertainment and financial services. Cross-border trade in architectural and engineering services tends to rise along with the complexity and specialization of the services involved, which are linked to the construction services sector, where many firms in Asia and Latin America are able to offer a wide range of operations and maintenance services post-construction, based on maintenance management software. Computer software represents one of the largest segments of services delivered through the cross-border mode of supply, with a growing number of developing countries using the INTERNET to both market and deliver these services; the case of the Indian software industry is described in Box 1 below. Cross-border supply of health services from developing countries is becoming economically significant, with a growing number of commercial Telemedicine links now operating in Asia and Latin America, on-line diagnosis services being offered by China throughout South Asia, and medical samples going for diagnosis to Mexico from Central America. Many medical facilities in North America are now having their medical records or patient interviews digitally transcribed in Bangladesh, India, Pakistan, the Philippines or Zimbabwe. The value of Internet-based services is estimated to be more than $ 300 billion. The United States accounts for more than 90 per cent of global e-commerce revenues and this of course relates to the significance of its domestic market. The main exporters in terms of export share of e-commerce revenue, however, are Canada, Australia and New Zealand, and the EU, particularly the United Kingdom.

Box 1

Case study of software development services in India

The rapid growth of the Indian software services industry with a strong export orientation is owed to government strategies, a low-cost, highly skilled workforce, and policies to develop telecommunications infrastructure. India's software exports have been growing by 50 to 60 per cent for the past seven years and are estimated at $1 billion. In November 1986, the Government of India made the first software policy announcement which was aimed at promoting the integrated development of software for domestic and export markets, capturing a sizeable share of export markets and simplifying the existing procedures in order to enable the software industry to grow at a faster pace. Between 1985 and 1990, since the domestic market for software was very small and telecommunications facilities relatively poor, Indian software companies concentrated on rendering on-site services to overseas clients, which comprised 80 per cent of export earnings. Major relaxation in the import scheme for computer hardware and software culminated in duty-free treatment in 1986. Foreign investment was welcomed and import of technology was permitted. Electronic hardware and software technology parks were established as customs-bonded areas for encouraging export-oriented production, and duty-free imports of equipment were allowed against the acceptance of export performance obligations. Protection of software was brought within the purview of the Copyright Act in 1994, and the software industry was granted tax exemption on export-related profits. To spur dynamic growth, further measures, including fiscal incentives, were adopted to encourage the creation of venture capital funds, give employees stock options with a lower incidence of capital gains tax when stockholdings are liquidated, and allow the weighted deduction of 125 per cent of expenditures on research and development. In addition,

income tax exemption has also been allowed to support developers of computer software, who may not be exporting software themselves but who provide development inputs to the exporting companies.

Indian software developers have been mainly engaged in developing customized software for specific end-use applications, rather than in developing packaged software for standardized applications (such as inventory control) which offer not only better margins but also the advantage of size and volume. The developers have developed subsystems that go into the final product for major telecom/datacom equipment vendors. They have also developed skills in systems software and embedded software segments which can enable them to go in for complete systems integration and product development. WIPRO is also focusing on the health care, finance, retail and utilities areas to increase its share of higher value-added work. The Pentafour Group have acquired expertise in areas such as banking and insurance and are one of the principal partners in India of leading United States computer companies, such as IBM, EDS and Computer Associates. Infosys Technologies is building its future strategies around the Internet, with a special focus on electronic commerce. Satyam Computers have diversified into services linked with enterprise solutions, Internet integration, enterprise resource planning (ERP) systems, process consultancy and product development. The two leading computer-education companies, NIIT and APTECH, have begun diversifying into software development. Software services contributed 42 per cent of NIIT's total revenues of Rs. 6,484 million ($152.6 million) in 1998-1999, while APTECH aims at raising the share of software in its turnover from 10 per cent at present to 30 per cent over the next 3 to 4 years. APTECH's sales revenues in 1998 were $65.3 million.

One of the problems faced by Indian software companies as they strive to climb the value-addition ladder and build up turnover volumes is the high rate of turnover of professional staff. Of the 11,000 personnel employed in the software business by India's leading software firm, Tata Consultancy Services, the annual loss is as high as 2,500. Some 90 per cent of those who leave go overseas, mostly to the Silicon Valley (United States) and to the United Kingdom. They leave carrying with them three to seven years' experience on the 'average' gained with the firm. In man-year terms, the knowledge loss sustained by this level of turnover becomes much more significant, since new recruits will take a couple of years to build up comparable work experience and proficiency. To make up for this loss, more high-quality personnel will need to be turned out by educational institutions, such as science and engineering colleges and business schools. One of the main impediments in moving into higher value-added subsectors is the lack of adequate "domain knowledge", i.e. knowledge of the potential client's business, customers, vendors and financial details – information which a major foreign company may not be willing to share with an Indian software company. The way to get past this problem is to build credibility, and one way of achieving this is through build up of sheer size. By successfully exporting to the world's largest software market, the United States, and getting its shares listed by NASDAQ through a recent issue, Infosys Technologies has taken a strategic step to enhance its credibility worldwide.

Indian software exports have benefited from the following supportive factors: (i) availability of competent English-speaking professionals in the fields of mathematics, engineering and business studies, along with trained personnel who have received diplomas in computer education; (ii) strong export orientation of Indian software firms; (iii) enabling work platforms created by governmental policy measures, such as the establishment of software technology parks and export processing zones where export-oriented units can access computer hardware and software on a duty-free basis; (iv) the granting of tax rebates on port-related profits of software companies; (v) strengthening of telecommunications infrastructure, both land-based and satellite-based, using digital switching/optical fibre/radio-communication devices; (vi) liberalization of imports of computer hardware and software by dispensing with quantitative restrictions and reduction of duties, in line with commitments made by India as a signatory of the plurilateral Information Technology Agreement (ITA) under WTO auspices; (vii) expansion of computer usage in domestic trade, industry and other services with attendant growth in demand for software support services; (viii) expansion of exports into the software "products" sectors, with standardized packages for large-volume applications, and tapping the extensive data entry and

data processing activity at the lower end of the computer services market, e g processing of airline tickets, credit card payment counterfoils, and so forth, as well as venturing into the systems software area

A. Constraints

45 The opportunities offered by electronic commerce include access to new markets, cost savings (e g lower personnel costs, lower cost of Internet e-mail), time savings (e g quicker response to markets) and quality benefits These opportunities, however, are significantly constrained by the stage of development and interconnectivity of the telecommunications infrastructure It should be noted that 65 per cent of the total households in the world do not have a telephone, and in low-income countries there are only 2 5 lines per 100 people, as compared to 54 lines per 100 people in developed countries This has resulted in 96 per cent of Internet host computers being found in high-income countries Other constraints relate to monopoly pricing for long-distance telephony connections and distance-based pricing that disadvantages countries further removed from lucrative developed markets, costing of the full circuit for Internet, lack of trust, uncertainty about the regulatory environment, and lack of human resources Under these unfavourable circumstances opportunities currently offered by e-commerce are under heavy constraints

46 At present, only a few developing countries are using the Internet for accessing foreign markets to supply services Lack of awareness among developing country companies of the relevance of digital economy, and the high cost ($ 250,000 to $2 million) of setting up a significant e-commerce site (even if such costs may be lower than capital costs for conventional outlets), have contributed to this To maintain the website and continuously upgrade and redesign also involves considerable expenditure For the time being, therefore, developing countries are mainly consumers of Internet-based services and use the Internet to access consumer and marketing information and use electronic mail to communicate with customers and other companies or to advertise service products Other uses relate to human resource management, financial transactions, public relations, and on-line tools, such as credit assessment and customer service

B. Preconditions for success

47 Major elements in the success of developing countries that are exporting or have the potential of exporting through electronic commerce are the following government measures (i) giving highest priority to the policies required for information technology, telecommunications infrastructure and Internet development, (ii) improved public network infrastructure by encouraging competition, including through liberalization, (iii) promotion of Internet access points to the public and provision of a special dialing number to ensure a favourable local service tariff for Internet services, (iv) creation of competitive markets for Internet service providers, and (v) adopting cost-based tariffing in leased lines for Internet services

48 Efforts need to be made to ensure that access of developing countries to technology and transborder data flows is not constrained, as information constitutes an increasingly important factor of production Information asymmetry between developed and developing country suppliers is particularly important in services, and ways and means need to be found to improve access to information The technological leadership of developed countries in this field creates a dynamic comparative advantage and could result in consolidation of the dominant market position of those already in the technological lead

C. Issues requiring further consideration

49 Priority attention will be needed to establish the necessary legal and financial infrastructure for dealing with commercial code, intellectual property rights, domain names, privacy, security, customs, taxation and electronic payments, as well as to build human resources by improving education in information technologies and computer and language skills, develop contents and provide market access for suppliers from developing countries. Access to the latest technology (including high-speed access to networks) will be crucial to ensure that developing countries benefit from e-commerce.

50 Some of the other issues requiring further consideration are the impact of competition, particularly by dominant brand names of developed countries, on market access by SMEs from developing countries. These SMEs suffer from low levels of productivity, poor product quality and lack of access to credit and training, but nevertheless have an important role in generating employment. The impact of capital outflows from developing countries due to e-commerce will also require further attention. Prior to any political agreement at the WTO to continue the current practice of not imposing customs duties on electronic transmissions, and prior to any decisions which could affect the market access of developing countries and their policy flexibility, the following issues will also require special attention.

51 The market structure is being affected by e-commerce and there is a need to develop competition policy-related disciplines in this area to ensure SMEs from developing countries fair competition. Safeguards need to be established to ensure that dominant suppliers do not abuse their position in the market. The impact of replacement of traditional distribution channels by direct contact between supplier and consumer, or by new channels developed by "infomediaries", well-known brand names, and domain names on the Internet also requires attention.

52 A wide range of service transactions are carried out through e-commerce and thus are already covered by the GATS and some schedules of commitments. Some issues arising from e-commerce will need to be addressed in the future GATS negotiations, e.g. transmission through the Internet of services where no commitment on market access has been made, domestic regulation, and the distinction between goods and services. On the other hand, there are a wide range of e-commerce regulatory issues where new multilateral disciplines might not be the appropriate response. Such questions will have to be examined in future work on e-commerce.

53 The potential to provide cross-border services electronically could reduce dependence on either commercial presence (mode 3) or movement of natural persons (mode 4). Any information that can be digitalized can be manipulated and custom-designed at a distance. Although during the Uruguay Round the emphasis was on obtaining market access through commercial presence, it is expected that the next round will concentrate on the cross-border mode. The need for commercial presence could be reduced as a result of electronically facilitated cross-border trade. On the other hand, given significant restrictions on movement of natural persons, e-commerce could provide major opportunities to supply labour-intensive services through the cross-border mode. The distinction between modes 1 and 2 has given rise to difficulties. Some suggestions have been made to collapse the modes of supply in GATS or to create a fifth mode. Other approaches under discussion relate to distinction on the basis of whom the measure impinges on, or on the basis of presence of supplier or consumer in the relevant market or where the final consumption takes place. The impact of these approaches on the architecture of the GATS and the existing commitments needs to be given careful consideration.

54 Technological neutrality has been discussed extensively in relation to existing commitments on services. The understanding reached in the context of basic telecommunications provided that any basic telecom service listed in the schedules of commitments may be provided through any means of technology, e g. cable wireless or satellites, unless otherwise noted in the sector column. This does not mean that the notion of technological neutrality and access is automatically applicable to all sectors and modes without specific commitments on the electronic supply of services. During the Uruguay Round and the extended negotiations on basic telecommunications, few countries made commitments with e-commerce intention, except where commitments were made under the cross-border mode on specific sectors. In the future round of negotiations, the commitments on e-commerce could be clarified and restrictions on means of delivery of a service could be scheduled horizontally or as a national treatment restriction.

55 Different approaches have been put forward regarding the appropriate role of government in managing e-commerce. Most developed countries have attributed the important growth in e-commerce to the lack of a restrictive regulatory framework and government intervention. Coordination and regulation are however, unavoidable and cannot prudently be left only to the private operators. Governments will need to cooperate with the relevant United Nations organizations or specialized agencies to devise the appropriate regulatory framework in relation to fiscal issues, protection of confidentiality, management of domain names, jurisdictional questions, protection of intellectual property and encryption. To ensure conformity with standards, Governments will need to cooperate to harmonize and recognize each other's standards and qualifications. Ensuring conformity assessment would be all the more difficult in e-commerce, given that technically it is hard to establish control mechanisms for cross-border supply.

Conclusions

56 Some developing countries have adopted successful strategies of diversifying into export-oriented service sectors. Essential elements of such strategies have been to ensure that regulatory and fiscal impediments are removed, that there is a clear idea of the factors contributing to a competitive position, including existing skills and labour cost advantages, such as those prevailing in the goods sectors, climatic and geographical attributes, and cultural factors. The establishment of a supportive institutional structure at the national, bilateral and regional levels is usually required. Successful strategies require priority attention to be given to development of infrastructure, particularly the information/telecommunications infrastructure, a continuous process of upgrading technology, human resources and value-added is also required, particularly to avoid being short-circuited by technological advances. Access to financial resources or financing mechanisms is a vital element for service firms to remain competitive and to sustain their market position. It is essential to meet quality standards and cultivate an attractive image of the country.

57 Access to services, especially the "producer services", is essential for the acquisition of technologies and increased efficiencies in the development of both the goods and services sectors. The goods sector, including agriculture, manufacturing and natural resource extraction, can give rise to specialized knowledge and expertise which can subsequently be "externalized" and exported. The domestic regulatory environment can affect the competitiveness of services and in fact "breed" new services. In the telecommunications sector, privatization and liberalization can greatly strengthen export potential. More stringent and technically demanding regulations can give rise to a new national capacity, as in the case of the environmental services sector, where legislation introduced in OECD countries led to the development of a new sector which is now seeking

markets in the developing countries. In some developing countries, such as Brazil, this process is being repeated due to the introduction of regulations and contact with foreign service suppliers.

58. Successful strategies in developing service exports often require a multisectoral approach. For example, exports of health services through movement of patients can be hindered by the non-transportability of insurance services, and health service exports through the movement of persons can be impeded by problems relating to the recognition of professional qualifications. Service development strategies can require choices between competing objectives, there may be contradictions, for example, between air transport policies and policies aimed at maximizing tourist arrivals.

59. If the next set of multilateral negotiations on trade in services is to enhance the development of developing countries, it must be recognized that further liberalization of trade in services will provide meaningful export opportunities for developing countries only if parallel action is taken to assist these countries in enhancing their supply capacities. The effective implementation of provisions of Article IV, including in relation to access to technology, is crucial. The future GATS negotiations will provide an opportunity for developing countries to address barriers to their services exports. A key goal for developing countries is to achieve the managed liberalization of market access for their natural persons, through the reduction of the scope of, and introduction of more predictability into, economic needs tests, streamlining the issuance of visas and facilitating the recognition of professional qualifications. The liberalization of trade in services, notably through commercial presence, can make a major contribution to the achievement of developmental and social goals, if certain prerequisites are met. Liberalization commitments have to be devised in clear recognition of the specificities of the national service sector concerned and of the relationships between sectors. An adequate regulatory structure has to be in place prior to liberalization. Decisions as to where to make such commitments should take into account possible social, developmental or environmental "dividends".

60. Further sectoral analysis by the UNCTAD secretariat could be helpful in assisting developing countries to identify opportunities for service sector exports and to define their interests in the upcoming multilateral negotiations on trade in services.

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Item 6 of the provisional agenda

PROGRESS REPORT ON THE IMPLEMENTATION OF AGREED CONCLUSIONS AND RECOMMENDATIONS OF THE COMMISSION

Executive summary

In accordance with paragraph 24 of the guidelines on the efficiency and functioning of the UNCTAD intergovernmental machinery, adopted by the Trade and Development Board at its sixteenth executive session (decision 446 (EX-16) of 16 February 1998), the secretariat presents herewith a progress report on the implementation of agreed conclusions and recommendations addressed to the UNCTAD secretariat at the third session of the Commission.

GE.99-51053

Agenda item 3: Ways and means of enhancing the utilization of trade preferences by developing countries, in particular LDCs, as well as further ways of expanding preferences

1. *"UNCTAD should continue to analyse the importance of GSP schemes and other trade preferences, on the basis of quantified and statistically supported evidence. It should identify the real benefits obtained from trade preferences."* [para. 15]

2. **Action:** A study on the utilization of the schemes under the Generalized System of Preferences (GSP) has been prepared. The preparation of the study and the analyses of benefits derived from trade preferences required the updating of the UNCTAD GSP database with the most recent data made available by preference-giving countries. This involved substantial efforts in verifying the data and formating them according to the layout needed for reporting on utilization. The latest GSP data are available for the following preference-giving countries: Canada, the European Community, Japan, Norway, Switzerland and the United States of America. The establishment, maintenance and updating of this database are a precondition for carrying out analytical work and field activities on GSP. The cooperation of the preference-giving countries listed above in providing the most recent data is highly appreciated. It is hoped that other preference-giving countries will also soon provide their latest GSP data.

3. *"UNCTAD should continue to provide technical cooperation to preference-receiving countries, particularly LDCs and certain developing countries with structurally weak and vulnerable economies, with a view to increasing the utilization of trade preferences. Such technical cooperation should aim to enable these countries to hold workshops, carry out information activities and train their exporters themselves."* [para. 16]

4. **Action:** During the period under review, the secretariat has been able to organize only a limited number of seminars, mainly because of a lack of financial resources for GSP technical assistance and because of the need for additional staff. There was also a need to prioritize the use of staff resources, with the emphasis on revising and updating all GSP handbooks, which are the backbone of field activities. Almost all handbooks on GSP schemes have been revised and updated (see annex) and have been distributed to GSP focal points and Geneva-based delegations. Additional work has been carried out to build up the capacity at the national levels to train exporters through the establishment of the GSP website, as described below.

5. *"Owing to their administrative constraints, LDCs require direct technical assistance aimed at enhancing their human resource capacities for the more effective utilization of GSP preferences. This would need to include fortifying the existing GSP focal points or assisting in their establishment, and the provision of training materials."* [para. 17]

6. **Action:** The secretariat has developed a series of tutorials in the form of computerized presentations (in "Powerpoint") which are available on the Internet and will be distributed to LDCs' focal points on diskette and CD-ROM in the course of 1999. This material, together with the handbooks and information on GSP utilization rates at country level, constitute a comprehensive package designed to serve as basic training material for conducting domestic workshops.

7. *"UNCTAD should explore how new information technologies could be used to render technical cooperation in the areas of GSP and other trade preferences more effective. Many GSP information services and, to some extent, advisory services could be provided rapidly and cost-effectively to end-users in developing countries centrally from Geneva through communication channels such as the Internet and e-mail."* [para. 18]

8. **Action:** The GSP handbooks on the schemes of Canada, the European Community, New Zealand and Switzerland are available on the Internet at the following address:

http://www.unctad.org/en/techcop/trad0103.htm

While the current website is being updated with the new publications, a new GSP website is under preparation and will be available by mid-September 1999. It will contain: frequently asked questions on GSP; downloadable Powerpoint presentations on the GSP schemes and rules of origin to be used for training purposes by the GSP focal points; all handbooks on the GSP schemes and related database; the handbook on GSP rules of origin; and a searchable database on GSP product coverage containing Most-favoured-nation and GSP rates. In the near future, the full GSP utilization database will be put on-line for consultation by focal points.

9. *"In conducting its future analysis and technical cooperation related to preferences, the UNCTAD secretariat should continue to ensure its complementarity and added-value with respect to other work in this area."* [para. 19]

10. **Action:** The analysis and technical cooperation activities conducted by the secretariat are highly complementary, including with other related work. This is ensured through the continuous exchange of information and experiences among staff. The staff carrying out analytical work and those conducting technical cooperation activities interact on a daily basis, and both liaise continuously with GSP officials in preference-giving and preference-receiving countries.

Agenda item 4: Scope for expanding exports of developing countries in specific services sectors through all GATS modes of supply, taking into account their interrelationship, the role of information technology and of new business practices

(a) Prepare jointly with WTO an assessment of the impact on developing countries of liberalization under GATS;

Action: Following consultations with the secretariat of the World Trade Organization (WTO), it was decided that the UNCTAD secretariat would await the background document on the assessment by the WTO secretariat of the particular interests of developing countries, particularly those related to the objectives of article IV of the General Agreement on Trade in Services (GATS), as stipulated in article XIX.2. The UNCTAD secretariat provided the WTO secretariat with a summary of its findings on the development of service sectors in developing countries as a contribution to the assessment exercise in the WTO Council for Trade in Services, and is prepared to provide further elements and findings from its ongoing work to complement the work already undertaken by the WTO secretariat. The sectoral work undertaken by UNCTAD contains a wealth of sector-specific data and analysis which are directly relevant to the objectives of increasing the participation of developing countries and of formulating guidelines for a future round of negotiations on services. The States members of WTO have not yet agreed that work on a joint assessment should be undertaken by the two secretariats; accordingly, the UNCTAD secretariat's summary of findings, mentioned above, will be made available to the Commission as background document UNCTAD/ITCD/TSB/7.

(b) Undertake a systematic analysis to identify possible opportunities for expanding trade, so as to facilitate the preparation of requests in the GATS negotiations;

Action: The secretariat has carried out analytical work to identify possible export opportunities in six sectors in which developing countries have a revealed or potential comparative advantage, particularly through the movement of natural persons, namely: professional and business services such as computer and office services; health services; tourism; construction; audiovisual services; and transport. The main findings of this work are contained in TD/B/COM.1/28, prepared under agenda item 4 of the current session of the Commission. The secretariat has also prepared background materials to assist developing countries in identifying possible issues for their positive agenda for trade in services and to facilitate the preparation of their requests in the future round of negotiations on services.

(c) Analyse recent developments in trade and competition issues in service sectors;

Action: The analysis is contained in a study of recent developments in the air travel and tourist sectors of interest to developing countries. The study maps out the market structures and anti-competitive practices that appear in the air transport and tourist sectors, by focusing first on the distribution mechanisms used in the tourist sector, and [illegible]

in which the adverse effects of the anti-competitive practice are felt. The study also concludes that developing countries are not at present able to cope with anti-competitive practices without the active cooperation of developed countries competition authorities. The study will be published soon.

Competition policy issues in the service sector have been addressedin recent meetings. At its second session, held from 7 to 9 June 1999, the Intergovernmental Group of Experts on Competition Law and Policy recommended that the Fourth United Nations Conference to Review All Aspects of the Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices, to be held in September 2000, *should* consider, *inter alia*, competition policy issues in telecommunications and competition policy and its implications for regulatory and legislative reforms. The Third Joint WTO/UNCTAD/World Bank Symposium on Competition Policy and the Multilateral Trading System, held on 17 April 1999, devoted one of its sessions to competition policy and recent developments in the service sector.

(d) Continue work on the MAST (Measures Affecting Service Trade) database with a view to supporting countries which wish to implement it to strengthen their negotiating capacity, and evaluate its functioning with a particular focus on the utilization of recent developments in the field of informationtechnology.

Action: The MAST is being implemented as a means of promoting transparency among trading partners in the area of services. It is designed to allow userfriendly access for negotiators, policy makers, business persons and academics to legal information on measures applied to services as defined by GATS. The information is structured according to: (i) the country that applies the measure; (ii) the servicesector or subsector affected by the measures as defined by GATS and the Central Product Classification; (iii) the mode of supply affected; and (iv) the kind of measures used in connection with article VI, on domestic regulations, article XVI, on market access, ad article XVII, on national treatment. At present, the database is available in CD-ROM format, with a set of Windows applications. Downloading from the UNCTAD websitewill be possible by the end of 1999.

(e) Assist developing countries, especially LDCs, as a follow-up activity of the High-level Meeting on Integrated Initiatives for Least DevelopedCountries' Trade Development, in improving their supply capacity in the area of trade in services through, inter alia, human resource development, institutionalcapacity-building, access to relevant new technologies and setting up adequatelegislation.

Action: A number of LDCs are included among the CAPAS participants in its current

WTO Ministerial Conference, UNCTAD organized a high-level workshop for LDCs which dealt with the GATS negotiations. The regional project for Africa carried out by the United Nations Development Programme (UNDP), in which UNCTAD participates, will be dealing with trade in services.

(f) Continue work on the Coordinated African Programme of Assistance in Services (CAPAS) and extend it to other interested African countries;

Action: CAPAS was launched by UNCTAD in 1992 with the objective of strengthening the capacity of participating countries to formulate policies for the development of their service capacity as an instrument for development and trade. Over 20 African countries have benefited from this programme, which is currently in its third phase. Phase II, which involved studies of national financial and basic telecommunications sectors, was concluded at a meeting held in Mauritius in December 1998. Current activities involve preparations for three subregional meetings in late 1999, at which each participating country will present at least one study on a national service sector. A wide range of services will be covered, including air, land and maritime transport, tourism, audiovisual services, health, energy and environmental services, business services and electronic commerce. Work will also involve integrating participating countries into the MAST database, and examining the decision-making process in selected countries in formulating negotiating positions on trade in services. These seminars and the follow-up work are expected to assist the CAPAS countries to participate more effectively in the negotiations on trade in services and to better coordinate their position at the subregional level. As support to CAPAS from the traditional sources of funds is diminishing, efforts are being made to obtain support from other donors, including UNDP.

(g) Take part in an international conference in Tunisia, organized by the World Tourism Organization, to consider ways and means of improving the relationship between developing countries' tourism service suppliers and travel agents from consumer countries in order to achieve a sustainable tourist industry;

Action: The UNCTAD secretariat collaborated with the Tunisian authorities and the World Tourism Organization in organizing the conference and took part in it. The conference made it possible to initiate a dialogue amongst participating experts with a view to proposing concrete solutions to the main problems that arise in sharing the benefits arising from international commercial transactions in tourism. Furthermore, participants in the conference considered that the current and future international trade agenda, such as the upcoming negotiations on trade in services, was of crucial importance for the partnership between the public and private sectors in both originating and host [illegible]

(h) Prepare, in cooperation with WTO, a list of economic needs tests in the schedules of specific commitments under GATS and propose ways and means to introduce a greater degree of transparency and predictability in the application of such tests;

Action: A list of economic needs tests will be made available to the Commission as background document UNCTAD/ITCD/TSB/8.

ANNEX

List of GSP publications, 1998/99

GSP handbooks (year of publication)	Languages	Document symbol
Handbook on the scheme of Switzerland (1998)	English only	UNCTAD/ITCD/TSB/Misc.28
Handbook on the scheme of Norway (1998)	English only	UNCTAD/ITCD/TSB/Misc.29
Handbook on the scheme of Japan (1999)	English French Russian	UNCTAD/ITCD/TSB/Misc.42
Handbook on the scheme of the U.S.A. (1999)*	English only	UNCTAD/TAP/163/Rev.13
Handbook on the scheme of Canada (1998)	Arabic English French Russian Spanish	UNCTAD/TAP/247/Rev.3
Digest of GSP Rules of Origin (1998)	Arabic Chinese English Russian	UNCTAD/TAP/133/Rev.7
Handbook on the scheme of New Zealand (1999)	English only	UNCTAD/ITCD/TSB/Misc.48
Handbook on the scheme of the Slovak Republic (1999)	English only	UNCTAD/ITCD/TSB/Misc.50
Handbook on the scheme of Poland (1999)	English only	UNCTAD/ITCD/TSB/Misc.51
Handbook on the scheme of the European Communities (1999)	Arabic English Spanish	UNCTAD/ITCD/TSB/Misc.25/Rev.1

* Since the GSP scheme of the United States was due to expire on 30 June 1999, this is a preliminary document. A revised edition will be published as soon as the scheme is renewed.